INTRODUCTION
TO
CORPORATE FINANCE

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PREFACE

In recent years many books have been published on advanced and elementary finance, but there has been available no elementary book of business cases and problems which could be used either separately or with the many textbooks. The present volume has been prepared to fill this need and to meet the requests of teachers who desire a series of corporation finance problems with introductory text material for beginning courses in this subject.

The plan of this book does not follow that of the advanced problem books. There is a general introduction to the book as a whole, as well as a series of introductory paragraphs to each of the eight sections. These introductory paragraphs were written not so much to present complete summaries as to furnish beginners with an aid in grasping quickly the full significance of the scope of each section. The cases and problems cover not only corporate structure, financial instruments, and questions of financial policy and management, but also certain of the relationships existing between corporations and the law and between trading or industrial concerns and such financial institutions as commercial banks and investment banking houses. The necessity for these brief excursions into investment and commercial banking becomes evident upon any examination of the part usually played by such concerns in the financial affairs of a corporation: the investment banking house plays a normal part in providing fixed capital for the corporation, and the commercial bank ordinarily serves the corporation by supplying working capital although its holdings of investments also supply long-term capital to corporations.

The lists of selected reading references which appear at the end of each division are intended to aid the student in securing a broad grasp of the problems studied, as well as in arriving at logical and comprehensive answers to the numerous summary questions which also appear at the end of each section. The references are not exhaustive but are restricted to a limited number of frequently used finance books commonly found in college

libraries. An attempt has been made to keep the problems short wherever possible, and to focus attention first on the direct issue or issues and then on the other important finance problems and principles involved in each case. The questions at the end of each case will suggest to the beginner the many ramifications of the problem while the questions at the end of each section will help the student to see how the problems are interrelated.

No book represents solely the work of its authors, and this is particularly true of a problem book. The problems were obtained from many individuals and companies, and prepared with the assistance of many people, to all of whom we extend our thanks.

First acknowledgment for this book is due to two members of the Faculty of the Harvard Business School, Dean Wallace B. Donham and Professor Melvin T. Copeland. Dean Donham contributed direction, encouragement, and valuable suggestions; and Professor Copeland, as former Director of the Harvard University Bureau of Business Research, laid the necessary groundwork for the collection and classification of business cases and problems. We take this opportunity to express our appreciation for the advice of Professor Nathan Isaacs on the parts of the book relating to corporate finance and the law. We acknowledge also the assistance of Assistant Dean Philip Hoppin, of Mrs. Shirley Carlson, Miss Marion White, and Miss Dorothy Moody, of the School's staff, and of Mr. Albert O. Greef and Mr. Andrew Towl.

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Soldiers Field,
Boston, Massachusetts,
July, 1936.

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INTRODUCTION

Finance in its broadest aspects deals with the securing, controlling, and distributing of funds, public as well as private. This book, however, treats mainly the financial problems of the corporation. The problems run the gamut of situations faced by officers of both large and small corporations under various conditions.

Developments in recent years have led to much confused thinking on the nature of finance, its functions, and its economic justification, resulting chiefly from a lack of general knowledge of the subject. Under much of the present-day interpretation, when the country indulges in an orgy of speculation and the public pays, as it invariably does, we blame finance; if abuse in the use and power of holding companies is revealed, we blame finance; if bankers are alleged to be heartless in pressing for liquidation of loans or shortsighted in refusing to lend, again we blame finance.

Doubtless much of the confusion about the subject comes, first, from its great scope and complexity, and secondly, from the loose terminology in general use. One can only conclude that in our thinking the term "finance" has become all-inclusive, so that without some definition or limitation it has little significance. These hazy impressions are most unfortunate, because finance performs an inevitable and valuable function in even the simplest of our economic transactions, quite apart from the popular concepts of finance prevailing among the inexperienced.

As an accessory to the development of the corporation, finance has contributed an important element in providing "exchangeability" of capital values by means of financial instruments such as notes, bonds, and stocks. These financial instruments in turn have made possible the establishment and growth of highly organized exchanges providing ready markets for securities.

It is true that certain predatory interests have used both the corporation and its financial instruments for selfish and unsocial purposes. To curb such practices effectively and at the same time to retain the benefit of the worth-while and important service of corporation finance as an aid in sound business transactions are the problems of the present and future. They can be solved only by a careful and thoughtful study of the sound principles of

corporation finance to determine what is significant and worth preserving. This book is planned to permit the examination of problems in corporation finance in the light of public welfare as well as from the point of view of private profit. Our modern financial machinery has become so complex, so interwoven in the lives of the American people, that the social point of view must be given constant consideration in the determination of sound and effective financial policies.

Nearly all of the cases in this book deal with industrial corporations, both large and small. Because of the limitations of space no cases relating to corporations set up for the handling of family investments, or created as foundations for the distribution of grants for charitable purposes, have been included.

THE CASE METHOD

The case method of study is used in most law schools, in many schools of business, and in courses in business economics. It is adapted to those fields where reasoning, flexibility of thinking, and power of analysis are required. Montaigne in the sixteenth century felt the need of a critical approach to study when he wrote as follows:

> I would have the tutor amend this [the old] method, and at the outset, in order to test the capacity of the mind he has charge of, he should put it on trial making his pupil taste of things, and to discern and choose them of his own accord, sometimes opening out the path to him, and sometimes leaving him to open it out to himself. I would not have him always start the subject and monopolize the speaking, but to listen while the pupil speaks in his turn. . . .
>
> Let the tutor demand of him an account not only of the words of his lesson, but of their meaning and substance, and let him estimate the profit he has gained not by the testimony of his memory, but of his life.[1]

The advantages of teaching with cases and problems are many: this method describes the interesting conditions present in real companies; it develops orderly thinking; it teaches an approach to a specific problem useful in its application to many problems; it permits constant repetition of principles, yet avoids monotony

[1] Trenchmann, E. J., *Essays on Montaigne*, Oxford University Press, London, 1927, vol. I, p. 148.

because of the differing circumstances; and it requires the student to take specific facts and from them to deduce guiding principles. It not only forces students to organize their thoughts and to develop a logical approach to problems, but also stimulates their intellectual curiosity.

Objections have been raised to using cases and problems for teaching a subject as broad as corporation finance, on the ground that it is a slower method than the process of absorbing knowledge from lectures and readings. This criticism has arisen because too much time has been spent on the main issues of cases. The difficulty may be met by careful attention to the various implications of the problems. Often from a single case many of the most important principles of the entire subject may be deduced. There is the further danger that the student may gain only a superficial knowledge and training because he will be unable to recognize many of the significant points involved even in a simple case. To avoid such a possibility the authors of this book have attempted to guide the student by the introductory sections, by the suggested reading references, and by leading questions. The necessity for flexibility of thinking in corporation finance cannot be overemphasized. The facts in any problem are constantly changing; the possible solutions are many and are seldom determined by rigid formula. Fixed ideas on problems in finance probably furnish the gravest danger faced by any student of this subject.

An idea of the scope of problems and the detailed way in which they can be studied may be gained by reading the Wilson Metals Company case on page 167. The problem material containing the issue as to whether or not the company should pay cash or stock dividends or both is brief. To this, however, is added a student's analysis of this problem. The student who wrote this report had studied various cases relating to dividends but had never studied this specific case before. His report was written in three hours. The purpose in bringing this report to the attention of students of finance is to indicate the sort of analysis required for able handling of a comparatively short problem. It is not suggested that the report is conclusive or exhaustive. It is, however, an actual example, showing one student's approach, and it is indicative of the method employed in dealing with cases.

The foregoing brief discussion of the case method is included as an aid and a warning to those students using this book who

wish seriously to secure an appreciation of one of the most difficult divisions of business. Certain suggestions on the methods to be used in studying by the case method may be of value. A student should read widely on the subject covered by the cases, since they are intended only to introduce new areas. Suggested readings should be augmented by intelligent library browsing, by such readings as are suggested by the instructors in the course, and by following the daily press and such financial periodicals as the *Wall Street Journal*, *Barron's Weekly*, and the *Commercial and Financial Chronicle*. Furthermore, the wise student will not attempt to memorize cases or answers to specific questions. The quest is for underlying principles which should become part of a student's mental equipment.

In studying these cases it is imperative to find the "issue," the discovery of which gives direction to further study. The next step is the analysis of the problem. Upon this depends an adequate solution and thorough grasp of the principles involved. The analysis should involve a careful breaking down of the issue into orderly questions and a marshaling of the pros and cons of the arguments upon which judgment must be based. In arriving at conclusions the student should avoid at all times prejudices and preconceived ideas. The analysis should reveal the answer rather than cause the analysis to support previously conceived conclusions.

The student should also make a practice of arriving at his own conclusions through the logic of his analysis before exposing them to the attacks of his fellow students. Group discussion then is a valuable aid in solving the problems and is the approach commonly used by business executives in positions of responsibility.

The student should realize, finally, that the careless reading of a case results in superficiality. Each case must be worked through and thought through and examined on all sides for various possibilities, before a solution can be reached. A case studied without the use of pencil and paper means a case poorly and ineffectively prepared.

THE SIGNIFICANCE AND IMPORTANCE OF THE TIME ELEMENT

Time, with its accompanying conditions, is an element of paramount importance in the determination of financial problems and policies. Changing conditions play upon our financial structures

like the wind upon a weather vane. Underlying conditions of accepted standard practice and of public psychology in a certain period may make or break financial plans, whether for the launching of a corporation or the refunding of a bond issue. For example, in February, 1929, the Cleveland Tractor Company faced the problem of paying or refunding its First Mortgage 6% bonds which would come due in July, 1930. Because common stocks were then in demand, the company decided to float an issue of common stock in April, 1929, to raise cash with which to pay off the principal of the bonds. At no time from 1930 to 1936, however, would the officers of the company have had another opportunity to exchange debt for ownership because of the kaleidoscopic change in public sentiment and in general conditions during the depression years. To illustrate further, in 1935 the Chrysler Motor Company refinanced the outstanding $30,000,000 issue of Dodge Brothers 6% bonds largely by borrowing from banks on serial notes. Probably at no time from 1928 to 1933 would this have been possible because of the nature of business conditions during that particular period.

In approaching any problem, therefore, the time element should be given early consideration. There are tremendous differences between such periods as 1921–1923, 1925–1929, and 1932–1935, and these differences are the result of shifting conditions which might affect directly the answer to many a problem in corporation finance. These changes are often related to the business cycle itself, which makes policies suited to one particular period unfit or unsound for consideration in another.

As a result of these constant changes foresight becomes an important factor in wise financial management without which a corporation would soon be in difficulties. Guiding principles are essential in the exercise of foresight. The careful executive charts his course keeping always in mind alternative solutions and programs to fit the possibilities of changed conditions.

In a field as complex as finance, to determine guiding principles is difficult, particularly when dealing with actual situations, the raw material of finance. When certain sequences or relationships are observed to happen over and over again, in a majority of similar instances, principles become established from the very recurrence of these experiences. It is the responsibility of the businessman and of the student of business to recognize these

principles and to adapt them to use in the solution of other problems in spite of variations in the practice of individual companies, the changes effected by time, and modifications occasioned by the human element involved.

CORPORATION FINANCE AND THE LAW

Of necessity there is a close relationship between corporation finance and the law, because the corporation itself is a result of the law and related to it by its very creation. The law dictates the rules of procedure for a corporation and its officials from the organization of the corporation until its possible eventual extinction by court action. The law, however, regulates and directs somewhat loosely within a huge framework which gives much freedom of action to corporation executives and others dealing with financial problems. Many legal problems are constantly arising in finance. The technical, legal phases of this subject belong naturally to corporation law and to lawyers. Students of finance, however, should have a general appreciation of the legal problems as they relate to the different problems of finance, in order to know the general areas of legal pitfalls and the precedents which have been set up to guide corporate action and corporate responsibilities.

Another reason for considering corporation law cases in connection with corporate finance lies in the fact that many of these cases present in a clear and concise manner descriptions of financial instruments, methods, policies, and principles which a beginner must have as background for his study of finance. Certain significant legal cases bearing directly on corporation finance have therefore been included in this book.

CORPORATION FINANCE AND THE GOVERNMENT

As indicated earlier in this section the relationship between finance and government is close, and the tendency seems to be in the direction of even closer ties. Among the many reasons for this relationship besides those already mentioned in discussing law and finance are three: (1) taxation, (2) regulation, and (3) direct participation.

Taxation.

Federal, state, and muncipal governments levy many taxes on corporations, such as income, stock, license, franchise, real

estate, processing, excise, and stamp taxes. At almost every session of Congress or of the state legislatures new taxes are proposed and discussed for purposes varying from revenue to social experimentation. Examples of taxes proposed for purposes other than revenues are those directed against chain stores in order, ostensibly at least, to assist the small retailer. Taxes are definitely becoming more and more important in the life of a corporation. They may dictate the state in which it will be incorporated, the community in which it will be located, the profits which it may expect, the decision regarding the formation of subsidiary corporations, and occasionally the actual dissolution of a corporation.

Regulation.

For years corporations and their financial instruments existed and functioned without more than vague and nominal regulation by state and federal governments, although from time to time regulation was advocated. Agitation for regulation became particularly acute as an aftermath of the 1929 speculative boom and became a part of the 1932 political campaigns. Such drastic changes as have occurred in recent years, however, would not have been conceived possible several years ago, although the business world had become slowly accustomed to the regulation of railroads, public utilities, and banks. The Securities Act which was adopted in May, 1933, came as a shock to corporations and the financial world. That there was need for some kind of regulation few will deny; many would have welcomed such regulation. The uncertain provisions of the Securities Act were, however, deplored by almost everyone in a position of responsibility in business. Certain of its weaknesses were corrected in the second regulatory act, the Securities and Exchange Act, which was passed in 1934. Thus corporate finance entered in 1933 an era of direct governmental regulation.

Direct Participation.

Following the beginning of the depression in 1929, the Federal Government definitely participated in our financial activities much more than it had during previous depressions. The objective of most of this participation was to assist corporations where normal financial aid was not forthcoming because of abnormal conditions. These activities were carried out through different

organizations, chief among which were the Reconstruction Finance Corporation, the Federal Reserve System, Farm Credit Administration, Securities and Exchange Commission, Federal Housing Administration, and Federal Deposit Insurance Corporation. A brief description of several of these appears in the appendix of this book.

The primary aim of the Reconstruction Finance Corporation, for example, was to provide loans to railroads, industrials, and banks which could not otherwise secure help because of panic conditions. This objective was further expanded to provide funds for reemployment and thus to act as a positive stimulus to business. Some such philosophy seemed to be back of much of the other legislation in putting the government into direct financial relations with private business. The effect of these policies was felt by corporations in dealing with both working and fixed capital problems. The scope and importance of these governmental agencies is by no means fully realized at the present time.

INTRODUCTION TO CORPORATE FINANCE

I

THE CORPORATION

Today the predominant form of organization in American business is the corporation. Not so many years ago two other forms, single proprietorships and partnerships, were far more numerous than corporations, but since the Civil War corporations have been increasing rapidly in number. This trend may be traced directly to the growth of business, in both size and complexity of operations, and to the need for larger amounts of capital and for the protection of business men from incurring more than a limited liability.

It is difficult to define the term "corporation" satisfactorily. The classical American definition, that given by Chief Justice Marshall in the famous Dartmouth College case, is as follows:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property, without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men, in succession, with these qualities and capacities, that corporations were invented, and are in use. By these means, a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal being.[1]

In other words, the corporation is purely a creature of the state. Its rights, duties, and powers are to be sought first of all

[1] *Dartmouth College v. Woodward,* 4 Wheat. (U.S.) 518, 636, 4 L. ed. 629.

in its charter, which may be in a special statute drawn expressly for one corporation, but, more likely, is in a general statute available on like terms to all organizers. Then we must examine its certificate of incorporation, which includes a description of its financial set-up and its authorized purpose. Finally we must consider its basic agreements expressed in by-laws, stock certificates, and other documents connected with the issuance of securities.

The corporation is guided and directed from its inception by laws and regulations. Corporation laws among the forty-eight states vary greatly and are constantly being added to and revised. Hence, with the thousands of companies being incorporated each year, there is a tendency toward confusion. Suggestions have been made from time to time for a national corporation act, with a scope similar to that of our national bankruptcy act. The possibility of securing such an act, however, necessary it may be, appears remote, inasmuch as the various states are exceedingly jealous of their charter-granting prerogatives. Competition among states has developed in an effort to attract companies to incorporate within their various boundaries. New Jersey in the 1890's was one of the first states to pass "attractive" incorporation laws and thereby induced large numbers of companies to incorporate under its statutes. New Jersey was followed by Maine and in 1903 by Massachusetts. New York in 1912 legalized no-par stock. Delaware in recent years has passed laws of such scope that since 1922 more than half the largest companies chartered have been incorporated in that state. These many and conflicting laws pertaining to corporations have made corporation law one of the most important divisions of American jurisprudence.

Before the adoption of the Constitution there were very few corporations in this country, many of which were in ill repute. Except in such enterprises as banking and the construction and operation of turnpikes, canals, and bridges, the use of the corporate form of organization was not common during most of the nineteenth century. Railroads, however, because of large capital requirements, were nearly always incorporated. Some of the early corporations were forced out of business by the courts because they were being used as cloaks of deception under which to carry out without responsibility the wildest schemes. Slowly,

however, a solid and enduring foundation was laid for the modern corporation.

Public distrust continued, however, partly because of actual abuse of power by incorporated companies and partly because of a fear of the potential power resulting from their large size. The establishment of the Interstate Commerce Commission in 1887 and the passage of the Sherman Anti-Trust Act in 1890 and the Clayton Act in 1914 were designed to limit the growing power of the corporation.

In more recent years public interest in corporations, stimulated both by investment and by speculation, has greatly increased. With the growth in size of corporations and the distribution of ownership among large numbers of people, various means have been devised to concentrate control of the corporation. The distinction between voting and nonvoting stock, the waiving of so-called preemptive rights, whereby stockholders could participate proportionately in providing additional funds, and the extensive use of the holding company were all directed toward concentrating control. The absentee position of the stockholders has been criticized, as well as the fact that many stockholders have either neglected their duty of voting or have not been conversant enough with corporate affairs to vote intelligently. The concentration of control, of course, gives opportunity for abuse as well as opportunity for effective management.

During periods when profits have become relatively small and the dangers of reorganization have loomed, stockholders have been jolted into a realization of their positions as owners. Particularly during the severe depressions beginning in the years 1920 and 1929 the corporation and all those functions to which it gives rise have been subject to intensive public scrutiny.

Legislation, notably the Securities Act of 1933 and the Securities Exchange Act of 1934, has been passed to regulate security transactions and to supply the public—and particularly security-holders—with more complete information. Much of the more recent legislation has been based on the assumption that publicity of corporate affairs will aid in strengthening the soundness of the corporation.

The trend is evidently toward the point of view that a company which sells securities to the public is not a "private" business but a "public corporation," subject to governmental supervision.

Federal authorities have created a whole new body of administrative law which now has the weight of statute law.

Today, with the many changes and new laws, there has come a new emphasis upon the corporation and corporation finance. Officers, directors, and stockholders are perhaps more aware of their responsibilities than ever before. The growing influence of the government in business and finance has raised interesting questions which add zest to the study of finance.

1. ORDWAY BAKERY COMPANY

FORM OF ORGANIZATION OF AN INDIVIDUALLY OWNED ENTERPRISE

In April, 1924, Mr. E. A. Ordway asked the law firm of Upkin & Thorndike for advice on the formation of a partnership or corporation. Mr. Ordway had been in the bakery business all his life, and for 15 years had been the head of his own bread and pastry company. He gradually had built up the sales of the company until in 1923 they amounted to about $330,000. The net profit on these sales, before the salaries of Mr. Ordway and his sons were paid, was about $50,000 annually. The net worth of the company, including goodwill, was estimated at about $210,000, although the book value did not show this amount. The company's borrowing requirements never had been more than $35,000.

Mr. Ordway was about 70 years old; he had two sons, who were about thirty-five years of age, and three daughters. The company was organized as an individual proprietorship, and Mr. Ordway received all the profits. Although he shared these profits with his children, he paid taxes on them as though they were his personal income, and thus the surtaxes, which increased proportionately with the amount of income, were heavy. Mr. Ordway considered reorganizing the company for three reasons: first, he wished to divide the profits among his children in order to avoid the surtaxes on his income; second, he wished to provide that the control of the business would be divided between his sons after his death and that his three daughters would receive a small share of the profits; and third, he wished to retain full control of the company as long as he lived. With these ends in mind, Mr. Ordway planned to form a partnership, making his sons junior partners. According to this plan, the profits would be divided and the income surtaxes reduced. Mr. Ordway's control of the company, furthermore, would be assured until he died. He requested the law firm of Upkin & Thorndike to draw the papers necessary for the formation of this partnership.

The lawyers suggested that he might consider incorporation carefully before deciding upon the formation of a partnership. They reported that the total income taxes paid both by the company and by the individuals would amount to about 7% more if the company were a corporation than if it were a partnership. The income given away would not come under the gift tax, which was effective on all amounts over $50,000; and the inheritance taxes on Mr. Ordway's share of the company would be the same since the amounts inherited under either plan would be identical. It was estimated that legal fees, stamp taxes, and a charter necessary for incorporation would cost the company about $1,000.

1. What is the difference between a corporation and a partnership?

2. What problems should Mr. Ordway have studied in order to decide whether to form a partnership, or a corporation?

3. What should the decision have been?

4. This problem arose in 1924. What changes have been occurring since then which might affect your answer?

2. BUTTON *v.* HOFFMAN[1]

LEGAL DISTINCTIONS BETWEEN PARTNERSHIPS AND CORPORATIONS

Orton, J. This is an action of replevin in which the title of the plaintiff to the property was put in issue by the answer. In his instructions to the jury the learned judge of the circuit court said: "I think the testimony is that the plaintiff had the title to the property." The evidence of the plaintiff's title was that the property belonged to a corporation known as "The Hayden & Smith Manufacturing Company," and that he purchased and became the sole owner of all of the capital stock of said corporation. As the plaintiff in his testimony expressed it, "I bought all the stock. I own all the stock now. I became the absolute owner of the mill. It belonged at that time to the company, and I am the company." There was no other evidence of the condition of the corporation at the time. Is this sufficient evidence of the plaintiff's title? We think not. The learned counsel of the respondent in his brief says: "The property had formerly belonged to the Hayden & Smith Manufacturing Company, but the respondent had purchased and become the owner of all the stock of the company, and thus became its sole owner."

From the very nature of a private business corporation, or, indeed, of any corporation, the stockholders are not the private and joint owners of its property. The corporation is the real, though artificial, person substituted for the natural person who procured its creation and has pecuniary interests in it, in which all its property is vested, and by which it is controlled, managed, and disposed of. It must purchase, hold, grant, sell, and convey the corporate property, and do business, sue and be sued, plead and be impleaded, for corporate purposes, by its corporate name. The corporation must do its business in a certain way, and by its regularly appointed officers and agents, whose acts are those of the corporation only as they are within the powers and purposes of the corporation. In an ordinary copartnership the members of it act as natural persons and as agents for each other, and with unlimited liability. But not so with a corporation; its members, as natural persons, are merged into the corporate identity. . . . A share of the capital stock of a corporation is defined to be a right to partake, according to the amount subscribed, of the surplus profits obtained from the use and disposal of the capital stock of the company to those purposes for which the company is constituted. . . . The corporation is the trustee for the management of the property, and the stockholders are the mere cestui que trust. . .

[1] Supreme Court of Wisconsin, 1884. 61 Wis. 20, 20 N.W. 667.

. . . The property of the corporation is the mere instrument whereby the stock is made to produce the profits, which are the dividends to be declared from time to time by corporate authority for the benefit of the stockholders, while the property itself, which produces them, continues to belong to the corporation. . . . The corporation holds its property only for the purposes for which it was permitted to acquire it, and even the corporation cannot divert it from such use, and a shareholder has no right to it, or the profits arising therefrom, until a lawful division is made by the directors or other proper officers of the corporation, or by judicial determination. . . . A conveyance of all the capital stock to a purchaser gives to such purchaser only an equitable interest in the property to carry on business under the act of incorporation and in the corporate name, and the corporation is still the legal owner of the same. . . . A legal distribution of the property after a dissolution of the corporation and settlement of its affairs, is the inception of any title of a stockholder to it, although he be the sole stockholder. . . .

These general principles sufficiently establish the doctrine that the owner of all the capital stock of a corporation does not, therefore, own its property, or any of it, and does not himself become the corporation, as a natural person, to own its property, and do its business in his own name. While the corporation exists he is a mere stockholder of it, and nothing else. The consequences of a violation of these principles would be that the stockholders would be the private and joint owners of the corporate property, and they could assume the powers of the corporation, and supersede its function in its use and disposition for their own benefit without personal liability, and thus destroy the corporation, terminate its business, and defraud its creditors. . . .

1. What is a corporation?
2. Was the plaintiff "the company" as he stated?

3. DELAWARE CORPORATION LAW

EXTRACTS FROM DELAWARE STATUTE RELATING TO INCORPORATION

Purposes for Which Formed:

Any number of persons, not less than three, may associate to establish a corporation for the transaction of any lawful business, or to promote or conduct any legitimate objects or purposes under the provisions of and subject to the requirements of this chapter as hereinafter provided, excepting for such purposes as are excluded from the operation of the general law by section 1 of article IX, of the constitution of this state, upon making and filing a certificate of incorporation in writing in manner hereinafter mentioned. . . .

. . . . . .

What Certificate Shall Set Forth:

The certificate of incorporation shall set forth:

1. The name of the corporation . . .

2. The name of the county and the city, town, or place within the county in which its principal office or place of business is to be located in this state . . .

3. The nature of the business, or objects or purposes proposed to be transacted, promoted or carried on.

4. If the corporation is to be authorized to issue only one class of stock, the total number of shares of stock which the corporation shall have authority to issue and (*a*) the par value of each of such shares, or (*b*) a statement that all such shares are to be without par value; or, if the corporation is to be authorized to issue more than one class of stock, the total number of shares of all classes of stock which the corporation shall have authority to issue . . .

5. The names and places of residence of each of the incorporators.

6. Whether or not the corporation is to have perpetual existence, if not, the time when its existence is to commence and the time when its existence is to cease.

7. Whether the private property of the stockholders or, in the case of a corporation which is to have no capital stock, if the members of such corporation shall be subject to the payment of corporate debts, and if so, to what extent.

8. The certificate of incorporation may also contain any provision which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders, or any class of the

stockholders, or, in the case of a corporation which is to have no capital stock, of the members of such corporation; provided, such provisions are not contrary to the laws of this state.

. . . . . .

10. The certificate of incorporation may also contain such provisions as may be desired limiting or denying to the stockholders the preemptive right to subscribe to any or all additional issues of stock of the corporation of any or all classes.

. . . . . .

State Fees.—The following taxes and fees shall be collected by and paid to the secretary of state, for the use of the state, upon the receipt for filing of any certificate or other paper relating to corporations in the office of the said secretary of state:

Upon the receipt for filing of an original certificate of incorporation, the tax shall be computed on the basis of one cent for each share of authorized capital stock having par value up to and including twenty thousand shares, one-half of a cent for each such share in excess of twenty thousand shares up to and including two hundred thousand shares, and one-fifth of a cent for each share of authorized capital stock without par value up to and including twenty thousand shares, one-fourth of a cent for each such share in excess of twenty thousand shares up to and including two million shares, and one-fifth of a cent for each such share in excess of two million shares; provided, however, that in no case shall the amount paid be less than ten dollars. For the purpose of computing the tax on par value stock each one hundred dollar unit of the authorized capital stock shall be counted as one taxable share.

Issuance of Stock:

The amount of capital stock with which the corporation will commence business shall not be less than one thousand dollars.

. . . . . .

. . . Subscriptions to, or the purchase price of, the capital stock of any corporation organized or to be organized under any law of this state may be paid for, wholly or partly, by cash, by labor done, by personal property, or by real property or leases thereof; and the stock so issued shall be declared and taken to be full paid stock and not liable to any further call, nor shall the holder thereof be liable for any further payments under the provisions of this chapter. And in the absence of actual fraud in the transaction, the judgment of the directors, as to the value of such labor, property, real estate or leases thereof, shall be conclusive.

. . . . . .

Kind of Stock:

Every corporation shall have power to issue one or more classes of stock or one or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value,

with such voting powers, full or limited, or without voting powers and in such series and with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of the certificate of incorporation or of any amendment thereto.

. . . . . .

Dividends; Reserves.—The directors of every corporation created under this chapter, subject to any restrictions contained in its certificate of incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (*a*) out of its net assets in excess of its capital as computed in accordance with the provisions of [other sections], or (*b*), in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired. . . .

. . . . . .

Directors and Officers:

The business of every corporation organized under the provisions of the chapter shall be managed by a board of directors, except as hereinafter or in its certificate of incorporation otherwise provided. . . .

. . . . . .

If the directors or officers of any corporation organized under the provisions of this chapter shall knowingly cause to be published or give out any written statement or report of the condition or business of the corporation that is false in any material respect, the officers and directors causing such report or statement to be published, or given out, or assenting thereto, shall be jointly and severally, individually liable for any loss or damage resulting therefrom . . .

. . . . . .

Powers:

Every corporation created under the provisions of this chapter shall have power:

1. *To have succession*, by its corporate name, for the time stated in its certificate of incorporation, and when no period is limited, it shall be perpetual.

2. *To sue and be sued . . .*

3. *To have a corporate seal . . .*

4. *To hold, purchase and convey real and personal estate*, and to mortgage or lease any such real and personal estate with its franchises . . .

5. *To appoint such officers and agents* as the business of the corporation shall require and to allow them suitable compensation.

6. *To make by-laws* not inconsistent with the Constitution or laws of the United States or of this state . . .

7. *To wind up and dissolve itself . . .*

8. *To conduct business in this state, other states . . .*

. . . . . .

Merger: Proceedings for:

Any two or more corporations organized under the provisions of this chapter, or existing under the laws of this state, for the purpose of carrying on any kind of business, may consolidate or merge into a single corporation which may be any one of said constituent corporations or a new corporation to be formed by means of such consolidation or merger as shall be specified in the agreement hereinafter required; the directors, or a majority of them, of such corporations as desire to consolidate or merge, may enter into an agreement signed by them and under the corporate seals of the respective corporations, prescribing the terms and conditions of consolidation or merger, the mode of carrying the same into effect, and stating such other facts required or permitted by the provisions of this chapter to be set out in certificates of incorporation, as can be stated in the case of a consolidation or merger, stated in such altered form as the circumstances of the case require, as well as the manner of converting the shares of each of the constituent corporations into shares of the consolidated corporation, with such other details and provisions as are deemed necessary.

Said agreement shall be submitted to the stockholders of each constituent corporation, at a meeting thereof, called separately for the purpose of taking the same into consideration . . .

1. What are the powers granted a corporation under Delaware corporation laws?

2. Do any of these seem exceptionally wide? If so, which ones?

3. What provisions in the Delaware laws on incorporation and organization do you think have most influenced enterprises to incorporate in this state?

4. What is a "preemptive right"?

4. ATLAS CORPORATION[1]

EXTRACTS FROM CERTIFICATES OF INCORPORATION SHOWING POWERS GRANTED BY STATE OF DELAWARE

We, the undersigned, in order to associate ourselves pursuant to an Act of the Legislature of the State of Delaware entitled "An Act providing a General Corporation Law" (approved March 10, 1899), and all amendatory and supplementary acts, into a corporation to carry on the business hereinafter stated, hereby certify as follows:

FIRST: The NAME of the corporation is ATLAS UTILITIES CORPORATION[1]

SECOND: The PRINCIPAL OFFICE or place of business of the corporation in the State of Delaware is to be located at No. 100 West 10th Street, in the City of Wilmington, County of New Castle . . .

THIRD: The NATURE OF THE BUSINESS of the corporation and the objects or purposes to be transacted, promoted or carried on are as follows:

To manufacture, improve and work upon minerals, metals, wood, oils and other liquids, gases, chemicals, animal and plant products, [etc.].

To manufacture, improve, repair and work upon any and all kinds of machines, instruments, tools, implements, mechanical devices, engines, boilers, motors, dynamos, rails, cars, ships, [etc.].

To own, purchase, lease or otherwise acquire lands and/or coal, oil, gas, mineral and timber rights in lands, and to produce therefrom coal, oil, minerals and other substances, [etc.].

To plan, design, construct, alter, repair, remove or otherwise engage in any work upon bridges, railroads, dams, canals, [etc.].

To buy, sell, exchange, trade, and otherwise deal in any and all kinds of manufactured articles, raw materials, minerals, animal and plant products, [etc.].

To carry on the business of trucking, warehousing and storage, including the storage of all kinds of goods, wares and merchandise, [etc.].

To acquire, buy, hold, own, lease, manage and control lands, interests in lands, concessions, railroads, canals, water courses, dams, irrigation systems, drainage systems, [etc.].

. . . . . .

To acquire, buy, hold, own, sell, lease, exchange, dispose of, distribute, deal in, use, produce, furnish and supply electricity, gas, light,

[1] Incorporated July 10, 1929. Extracts in this case include amendments to Feb. 1, 1932. Name changed to present title July 13, 1932.

heat, refrigeration, ice, water and power and any other power or force in any form and for any purpose whatsoever;

. . . . . .

To transact a general real estate agency and brokerage business and to act as agents, brokers or attorneys in fact for any persons, firms or corporations in buying, selling and dealing in real property and any and every estate or interest therein;

To carry on the business of general brokers and dealers in stocks, bonds, securities, mortgages and other choses in action . . .

To acquire, buy, hold, own, sell, exchange, apply for, control, dispose of, deal in, use, discover, improve, work upon, and grant licenses to use patents, patent rights, copyrights, inventions, improvements, processes, trade-marks and trade names;

To undertake, manage and control any and all kinds of scientific, historical, geographical, artistic or other enterprises and investigations, and to conduct, promote and finance any and all kinds of experiments, investigations, expeditions and explorations in aid thereof;

. . . . . .

To acquire by purchase, subscription or otherwise, and to own, hold for investment or otherwise, and to use, sell, assign, transfer, mortgage, pledge, exchange or otherwise dispose of real and personal property of every sort and description and wheresoever situated, including shares of stock, bonds, debentures, notes, scrip, securities, evidences of indebtedness, contracts or obligations of any corporations, associations or trust estates. domestic or foreign, [etc.].

. . . . . .

To borrow money, to issue bonds, promissory notes, bills of exchange, debentures, and other obligations and evidences of indebtedness . . .

. . . . . .

To purchase or otherwise acquire its own shares of stock (so far as may be permitted by law) and its bonds, debentures, notes, scrip or other securities or evidences of indebtedness . . .

To buy, sell and otherwise deal in open accounts and other similar evidences of debt or to loan money and to take notes, open accounts and other similar evidences of debt as collateral security therefor;

. . . . . .

The foregoing clauses shall be construed as objects, purposes and powers, and it is hereby expressly provided that the foregoing enumeration of specific powers shall not be held to limit or restrict in any manner the powers of the corporation.

Only the businesses for which a corporation may be formed under an Act of the Legislature of the State of Delaware entitled "An Act pro-

viding a General Corporation Law" (approved March 10, 1899), and all amendatory and supplementary acts, may be conducted by this corporation.

FOURTH: The total number of shares of all classes of stock which the corporation shall have authority to issue is One Million Five Hundred Thousand (1,500,000) shares, all without par value, of which One Hundred Thousand (100,000) shares shall be of a class designated Preferred Stock, Two Hundred Thousand (200,000) shall be of a class designated Preference Stock and One Million Two Hundred Thousand (1,200,000) shares shall be of a class designated Common Stock.

. . . . . .

PREFERRED STOCK

There shall be a class of stock of the corporation designated Preferred Stock and the shares of such class shall be issued in one or more series, within such class, each of such series to have such designation, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions, thereof, as are stated and expressed in the Certificate of Incorporation and in the resolution or resolutions providing for the issue of shares of such series adopted by the Board of Directors, as hereinafter provided.

. . . .

[Paragraphs granting directors wide powers over preferred issues.]

. . . .

General Provisions:

The following provisions shall apply to all the Preferred Stock of the corporation irrespective of series:

. . . .

PREFERENCE STOCK

There shall be a class of stock of the corporation designated Preference Stock and the shares of such class shall be issued in one or more series, within such class, each of such series to have such designation, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as are stated and expressed in the Certificate of Incorporation and in the resolution or resolutions providing for the issue of shares of such series adopted by the Board of Directors as hereinafter provided.

. . . .

[Paragraphs granting wide powers to directors.]

. . . .

General Provisions:

The following provisions shall apply to all the Preference Stock of the corporation irrespective of series:

. . . . . .

COMMON STOCK

There shall be a class of stock of the corporation designated Common Stock and the shares of the Common Stock shall not be entitled to any preferences and each share of Common Stock shall be equal to every other share of said stock in every respect.

. . . . . .

RIGHTS AND OPTIONS

The Board of Directors shall have power at any time or from time to time (without any action by the stockholders of the corporation) to create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes or of any series of any class or classes such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the Board of Directors. The terms upon which, the time or times, which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option shall be such as shall be fixed and stated in the resolution or resolutions adopted by the Board of Directors providing for the creation and issue of such rights or options, and, in every case, set forth or incorporated by reference in the instrument or instruments evidencing such rights or options.

GENERAL PROVISIONS

Vote on Increase of Stock:

The amount of the authorized Preferred Stock, Preference Stock or Common Stock may be increased or decreased by the affirmative vote of the holders of the majority of the stock of the corporation entitled to vote at the time of such increase or decrease.

. . . . . .

Rights of Directors in Declaring Dividends:

A director shall be fully protected in relying in good faith upon the books of account of the corporation or statements prepared by any of its officials as to the value and amount of the assets, liabilities and/or net profits of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid.

. . . . . .

SIXTH: The corporation is to have perpetual existence.

SEVENTH: The private property of the stockholders shall not be subject to the payment of corporate debts to any extent whatsoever.

EIGHTH: All corporate powers shall be exercised by the Board of Directors, except as otherwise provided by Statute or by this Certificate of Incorporation.

. . . . . .

THIRTEENTH: No stockholder shall be entitled as a matter of right to subscribe for, purchase or receive any shares of the stock or any rights or options of the corporation which it may issue or sell, whether out of the number of shares authorized by this Certificate of Incorporation or by amendment thereof or out of the shares of the stock of the corporation acquired by it after the issuance thereof, nor shall any stockholder be entitled as a matter of right to purchase or subscribe for or receive any bonds, debentures or other obligations which the corporation may issue or sell that shall be convertible into or exchangeable for stock or to which shall be attached or appertain any warrant or warrants or other instrument or instruments that shall confer upon the holder or owner of such obligation the right to subscribe for or purchase from the corporation any shares of its capital stock. But all such additional issues of stock, rights, options, or of bonds, debentures or other obligations convertible into or exchangeable for stock or to which warrants shall be attached or appertain or which shall confer upon the holder the right to subscribe for or purchase any shares of stock may be issued and disposed of by the Board of Directors to such persons and upon such terms as in their absolute discretion they may deem advisable.

1. Comment on the provisions of this certificate of incorporation.

2. What limitations are there to the powers of the Atlas Corporation and its directors in the certificate of incorporation? In the Delaware laws on incorporation?

3. What advantages and disadvantages are there for stockholders and for the management in enterprises incorporated in Delaware?

5. HECHT *et al.* v. MALLEY[1]

CHARACTERISTICS OF THE MASSACHUSETTS TRUST AS A TYPE OF BUSINESS ORGANIZATION

MR. JUSTICE SANFORD:

. . . . . .

The "Massachusetts Trust" is a form of business organization, common in that State,[2] consisting essentially of an arrangement whereby property is conveyed to trustees, in accordance with the terms of an instrument of trust, to be held and managed for the benefit of such persons as may from time to time be the holders of transferable certificates issued by the trustees showing the shares into which the beneficial interest in the property is divided. These certificates, which resemble certificates for shares of stock in a corporation and are issued and transferred in like manner, entitle the holders to share ratably in the income of the property, and, upon termination of the trust, in the proceeds.

Under the Massachusetts decisions these trust instruments are held to create either pure trusts or partnerships, according to the way in which the trustees are to conduct the affairs committed to their charge. If they are the principals and are free from the control of the certificate holders in the management of the property, a trust is created; but if the certificate holders are associated together in the control of the property as principals and the trustees are merely their managing agents, a partnership relation between the certificate holders is created. *Williams v. Milton*, 215 Mass. 1, 5, 102 N.E. 355; *Frost v. Thompson*, 219 Mass. 360, 365, 106 N.E. 1009; *Dana v. Treasurer*, 227 Mass. 562, 565, 116 N.E. 941; *Priestly v. Treasurer*, 230 Mass. 452, 455, 120 N.E. 100.

These trusts—whether pure trusts or partnerships—are unincorporated. They are not organized under any statute; and they derive no power, benefit or privilege from any statute. The Massachusetts statutes, however, recognize their existence and impose upon them, as "associations," certain obligations and liabilities.[3]

1. How does a Massachusetts Trust differ from a corporation?
2. What are its advantages and disadvantages?

[1] United States Supreme Court, 1924. 44 S. Ct 462.

[2] Such trusts also exist in other states. See generally, as to their characteristics, Sears' *Trust Estates as Business Companies* and Wrightington's *Unincorporated Associations*.

[3] By Chap. 441 of the Acts of 1909, §1, the trustees of "a voluntary association under a written instrument or declaration of trust the beneficial interest under which is divided into transferable certificates of participation or shares," are required to file copies of the instrument of trust with designated public officers; and by Chap. 184 of the Acts of 1916, such associations may be sued for debts, obligations, or liabilities, and their property may be subjected to attachment and execution as if they were corporations. See 2 General Laws, 1921, c. 182.

6. UNITED MILK PRODUCTS CORPORATION *et al. v.* LOVELL *et al.*[1]

RESPONSIBILITIES AND DUTIES OF DIRECTORS

SIMONS, Circuit Judge:

. . . . . .

The United Milk Products Corporation was incorporated in Delaware in 1925, and began business on January 1, 1926, carrying on its activities not only in Ohio but in a number of other states, and through a subsidiary in California. Its authorized capital stock was 250,000 shares preferred, par value $100 per share, and 250,000 shares of common without par value. The preferred stock was entitled to cumulative dividends of 7% per annum, $100 per share and accumulated dividends on dissolution, and a redemption value of $110 per share and accumulated dividends. The preferred stock had no voting rights, except that the consent of a majority was required for any amendment affecting its preferences. The common stockholders exercised all voting power, and subject to the rights of the preferred shareholders, were entitled to all of the earnings and to all assets upon dissolution. . . .

For the first five years of its existence the corporation was successful, and paid its preferred stock dividends, though no dividends were ever paid upon its common stock. In 1930 and 1931 it suffered substantial losses from operations, and defaulted on its quarterly preferred stock dividend due April 1, 1931, and thereafter no such dividends were paid. . . .

In 1931 the board of directors of the corporation concluded that readjustments, both in capital assets and in capital stock structure, were required. Not only had there been an impairment of capital assets by reason of operating losses which made it imposible to meet preferred stock dividends, and unlikely that such dividends could be resumed for a long time to come, but there had also been substantial depreciation both in tangible and intangible assets as carried upon the books. The current value of plants was approximately $300,000 less than their book value, and an intangible asset set up under the designation "Milk Supply," consisting of contracts with milk producers, which had been carried upon the books since organization at $4,364,662.08, no longer represented any real value.

Faced with continued operating losses, impairment of assets, a capital deficit in excess of three and a half million dollars, and without any early prospect of resuming dividends, the directors, upon con-

[1] Circuit Court of Appeals, Sixth Circuit, 1935. 75 F. (2d) 923.

sultation with the corporation's counsel, resolved upon a plan of reorganization. . . .

Before submitting the plan formally to the stockholders of the corporation, the directors discussed it in its general outline with a number of the larger holders of preferred stock, representing in all about one-half of the outstanding preferred stock, and including the chairman of the board of the Union Trust Company of Cleveland, which held a large amount of the preferred stock, both in trust and as collateral. After receiving informal approval of the plan by stockholders representing this number of preferred shares, the plan of reorganization in printed form was mailed to all common and preferred stockholders on March 5, 1932. Stockholders were advised of the existing situation, the improbability of early resumption of regular dividends on preferred stock, and the necessity of writing down the value of tangible and intangible assets. A majority assent to the reorganization was required from each class of stockholders, and on August 30, 1932, the holders of more than 75% of preferred stock, and of more than 70% of common stock, having filed their assent with the corporation, the directors declared the plan operative, and for the best interests of the corporation, and called meetings of both classes of stockholders for September 27 to take formal action. On September 22 the present suit was filed. No action having been taken on the prayer for temporary injunction, and after several adjournments of the stockholders' meetings, the plan was finally ratified on December 9, 1932, by the unanimous vote of all stockholders present in person or by proxy. The vote represented more than 77% of the preferred stock, and 72% of the common stock. Notwithstanding this approval, the assets were not immediately transferred, but notice was given to stockholders that the transfer would take place as of January 1, 1933. Meanwhile the state court had denied the petition for a temporary restraining order, and the case had been removed to the District Court, where nearly a year later and after consummation of the plan, it came to trial on December 15, 1933. By that time, all but 1.7% of the preferred stock, and all but 15% of the common stock, had been exchanged for shares in the new company.

The District Judge, conceiving the reorganization plan to be not only unfair to the preferred stockholders but entirely unnecessary for the attainment of the benefits to be derived from proper readjustments of capital, which could have been equally secured under an alternative plan submitted by some of the interveners but rejected by the directors, that losses suffered by the holders of preferred stock accrued by way of gains in equal amount to common stockholders, concluded that, in the originating, advocating, and carrying out of the reorganization, the directors disregarded their fiduciary relationship to the stockholders. He held some of them to have acted from fraudulent motives and self-interest in that their personal interest as common stockholders was not disclosed, and held others guilty of constructive fraud. While the reorganization undertaken was in the court's opinion permitted by the laws of Delaware, nevertheless, the breach of the fiduciary relation

rendered the steps taken in effecting it void and of no effect. Since, however, it would be inequitable to all parties to overturn the reorganization or the sale and transfer of assets thereunder, and impossible to restore the former status, it entered the decree for damages above indicated, and the appeal and cross appeal followed.

In considering the problem presented it must be understood that the internal management of a corporation is generally left to the discretion of its stockholders and directors, subject to limitations in its charter, and that courts will interfere in intra vires transactions only where there is misconduct equivalent to a breach of trust, or where directors stand in a dual relation which prevents an unprejudiced exercise of judgment. *United Copper Securities Co. et al. v. Amalgamated Copper Co. et al.*, 244 U.S. 261, 264, 37 S. Ct. 509, 61 L.ed. 1119; [etc.]. Also in determining whether there has here been any breach of a fiduciary relation it must be borne in mind that while the reorganization plan was initiated by the directors, it neither was nor could have been made effective without the approval of the preferred stockholders at a meeting duly called for that purpose. While the stockholders surrendered preferences reserved to them by their certificates, it was clearly within their competency to make such surrender, providing only that they were not prevented from exercising an informed judgment by any misrepresentation or concealment of material facts by the proponents of the plan. Courts will not substitute their judgment for that of the governing body of private corporations, except in the case of actual or constructive fraud.

There seems to us to be no basis in the record for a conclusion that the reorganization plan was in furtherance of a fraudulent conspiracy to mulct the preferred stockholders. Conspiracies are hatched in the dark, and sinister purposes are more readily achieved when time permits neither inquiry nor deliberation to thwart them. There was here neither secrecy nor haste. Before the plan was submitted formally to the stockholders, some eighteen of them, holding approximately 50% of the preferred stock, were consulted. Of these stockholders, six held no common stock whatsoever, seven were holders of preferred stock substantially in excess of their common stockholdings, three held an equal number of shares of both classes of stock, and but two held more of the common shares than of the preferred. Moreover, nearly a year elapsed between the presentation of the plan and the time it was put into operation. This is not the usual technique of fraudulent conspirators.

We come then to the plan as presented to the two groups of shareholders. It may be conceded that even without actual fraud there may be such misrepresentation, or such withholding of facts, however innocent in purpose, as to constitute constructive fraud. With that in mind, we have explored the plan, and accompanying communications from the directors. It is in our view impossible to say that the measure of sacrifice which the adoption of the plan would require of the preferred stockholders was in any way misrepresented or concealed. In express

terms the reduction of stockholdings, of dividends, of redemption rights, and of all other "rights accrued and to accrue" is placed before the stockholders.

It is contended, without reference to any specific language of the plan, that its general purport is to persuade the stockholders that in no other way than by its adoption could the benefits to the corporation resulting from writing down of capital assets or readjustment of capital structure, be achieved. We find nothing in the plan to warrant such implication. Nor is the fact that a better plan could in our present view have been devised, a test by which fraudulent conduct or the breach of a fiduciary relation is to be determined. The relative merits of plans of reorganization are subjects upon which the minds of reasonable men may, and almost universally do, differ. The common and the preferred stockholders accepted in overwhelming majority the plan as presented. Our only inquiry is as to whether they were by the directors prevented from exercising an informed judgment.

. . . . . .

Nor is there substance to the complaint that there was a breach of fiduciary relation in the voting of the proxies. The plan came to the stockholders with the advice of the directors that it be adopted and that proxies be forwarded to the offices of the company for that purpose. There could be no possible doubt in the mind of any preferred stockholder when he forwarded his proxy that he was sending it for the purpose of having his stock voted in favor of the plan.

. . . . . .

It is to be added that the later history of the preferred stock, its rise upon the market, the payment of dividends thereon out of earnings, the deposit of all but a small fraction thereof for exchange, the failure of any assenting stockholder to complain or to testify that he was deceived, are, while not controlling, important circumstances to be considered in determining whether there was any breach of confidence on the part of the directors, and so considered they are in negation of and not in support of the implications sought to be drawn by the plaintiffs.

1. From the above case, what do you believe the duties, responsibilities and liabilities of directors are?

2. From the evidence presented above, do the directors appear to have been guilty of misrepresentation?

SUMMARY QUESTIONS

1. Why is the corporation the most prevalent form of business organization today?

2. What are the advantages and disadvantages of the corporation as compared with a privately owned business and a partnership?

3. What are the responsibilities of a company's directors? To whom are directors responsible?

4. Why are so many companies incorporated in the State of Delaware?

5. In view of the nature of the corporation, is the trend toward giving more and more publicity to its affairs proper? What are the limitations?

6. Discuss the causes of corporate abuses.

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II

FINANCIAL INSTRUMENTS AND CAPITAL STRUCTURE

The capital of a corporation consists of its entire resources—the cash, buildings, equipment, inventory, receivables, trade-marks, and other assets which are used in carrying on its business. According to this definition, it makes no difference whether capital is borrowed or owned outright.[1] The capital represented by cash, inventories, securities, materials, and receivables, which constitute the changing assets of day-to-day operation, is called working capital; that represented by plant, machinery, and equipment is called fixed capital. A statement of a corporation's capital is found in its balance sheet. The individual items constituting its capital are listed under "Assets"; the sources of the funds which were used to acquire its assets are indicated under "Liabilities."

Ownership is represented both by preferred stock and by common stock. The latter commonly carries the sole voting privilege, though there are numerous examples of preferred stock with voting rights. Occasionally a stock is issued with multiple voting rights. An interesting example of a preferred stock with more than one vote per share is the Class A preferred stock of the Radio Corporation of America.[2] Preferred stock ordinarily has prior claim over the common stock both as to earnings and as to assets in liquidation. Dividends on preferred stock are generally at a stipulated rate, and may be cumulative or noncumulative. The funded indebtedness, the bonds and long-term notes of a corporation indicating capital borrowed, may be secured by mortgages on property or by the pledge of other assets of the corporation or they may be simply promises to pay.

Because financial instruments must indicate the legal rights and responsibilities of all parties concerned, it is important that

[1] It should be noted that capital as here used is not "capital" in the legal sense, which refers specifically to the contributions made by the owners of the business and is represented by capital stock.

[2] Called in 1936.

each security issue be carefully examined and its specific provisions studied. The provisions surrounding any given financial instrument are of greater significance than is indicated by the general class to which the instrument belongs. Bonds may under certain conditions actually have some of the characteristics of stocks; on the other hand, stocks may occasionally be similar to bonds.

The great variety of bonds, ranging from first mortgage and collateral trust bonds to debenture and income bonds, with varying rights and privileges, makes this subject one of infinite complexity and importance. Furthermore it is not simplified by an examination of the financial instruments representing ownership. They are not simply common and preferred stocks but vary even more in their provisions than do bonds.

The capital structure of a corporation is shown by the various classes and amounts of securities listed on its balance sheet under "Liabilities." The capital structure of a company is said to be sound when the financial instruments used are appropriate and in proper proportions to one another and to the earnings of the business. The question of the soundness of financial structure is not a subject for ready generalization. The proportion of debt to ownership (bonds to stocks) should be determined by the stability of earnings and the current and probable future conditions of the company, of the industry, of the securities market, and of business in general. It is usually unwise for a company with inherent instability of earnings to borrow for fixed capital purposes, because fixed interest charges prove burdensome when earnings are low. On the other hand, it is sometimes safe and cheaper for the owners of a company to borrow part of their funds at a reasonable rate of interest rather than to reduce their profits by sharing dividends with additional stockholders. Different types of business require different types of financing: the capital structure which might be sound for a public utility would prove cumbersome and unsound for a textile mill.

The problems in this section are intended to furnish an opportunity for the student to examine critically various types of financial instruments, to discover the relative advantages and disadvantages of these instruments, and to form some basis for judging the soundness of the capital structure of any given company.

1. THE YALE & TOWNE MANUFACTURING COMPANY WALWORTH COMPANY[1]

CAPITAL STRUCTURE OF INDUSTRIAL CORPORATIONS

The Yale & Towne Manufacturing Company manufactured building and automobile hardware as well as numerous metal products, including specialties such as electric industrial trucks. The company was organized under Connecticut laws in October, 1868, as Yale Lock Manufacturing Company; it was incorporated in February, 1882. In addition to its main plant located in Stamford, Connecticut, the company owned six other plants in this country, one in Canada, and several in Europe. The majority of the company's products were sold to the building and automobile industries.

The capital structure of The Yale & Towne Manufacturing Company comprised only common stock of a $25 par value.[2] The authorized amount of common stock was $25,000,000; less than half of this amount, however, was outstanding. The balance sheets of the company for 1930, 1932, and 1934 appear in Exhibit 1; and net earnings for the 7-year period, 1928 through 1934, in Exhibit 2.

The Walworth Company began business in 1842 under the name of Walworth and Nason, but was incorporated under the laws of Massachusetts in February, 1872, as the Walworth Manufacturing Company, successors to J. J. Walworth and Company. The company manufactured tools and supplies for steam, water, gas, and oil industries. Among the thousands of items manufactured by the company were certain products such as wrenches and valves which had a world-wide reputation. The Walworth Company had plants strategically located in different sections of the country to supply the national demand for its products.

The capital structure of the Walworth Company was composed of first mortgage bonds, debenture bonds, preferred stock,

[1] See Appendix I, "Analysis of Financial Statements," p. 345, for a brief explanation of common methods of analyzing financial statements, for use in this and subsequent sections.

[2] See Exhibit 6, p. 36, Atchison, Topeka and Santa Fe Railway Company case, for comparative capital structures.

EXHIBIT 1
THE YALE & TOWNE MANUFACTURING COMPANY
General Balance Sheet, as of December 31

	1930	1932	1934
ASSETS			
Plant and Equipment, Less Reserve for Depreciation	$ 9,150,901	$ 7,747,559	$ 7,555,320
Trade-marks, Patents and Goodwill	1	1	1
Current Assets:			
Cash	2,743,134	2,173,873	1,064,546
Accounts Receivable	1,952,508	976,684	1,484,641
United States and Other Marketable Securities	1,094,665	2,285,156	2,185,298
Inventories	7,079,622	3,030,481	3,720,767
Total Current Assets	$12,869,929	$ 8,466,194	$ 8,455,252
Company's Capital Stock Purchased for Resale to Employees*	...	55,513	177,153
Employees' Loans	475,011	322,370	239,819
Investment in and Advances to Subsidiary and Other Companies	737,938	683,920	584,638
Prepaid Insurance, Taxes, etc.	127,559	61,329	85,444
Total Assets	$23,361,339	$17,336,886	$17,097,627
LIABILITIES			
Capital Stock, Par $25	$12,166,400	$12,166,400	$12,166,400
Current Liabilities:			
Accounts Payable	390,074	214,585	382,766
Dividends Payable	243,328	120,339	71,033
Reserve for Federal and State Taxes	162,830	202,103	202,486
Total Current Liabilities	$ 796,232	$ 537,027	$ 656,285
Reserve for Contingencies	1,000,000		
Capital Surplus	1,627,400	768,192	768,192
Earned Surplus	7,771,307	3,865,267	3,506,750
Total Liabilities	$23,361,339	$17,336,886	$17,097,627
Net Working Capital	$12,073,697	$ 7,929,167	$ 7,798,967

* Represented by 5,500 shares in 1932 and by 13,100 shares in 1934.
Source: Poor's *Industrials*.

EXHIBIT 2
THE YALE & TOWNE MANUFACTURING COMPANY
Net Profit, Years Ended December 31

Year	Net profit	Net loss
1928	$2,152,631	...
1929	2,585,624	...
1930	...	$296,931
1931	...	726,250
1932	...	780,222
1933	36,307	...
1934	59,889	...

Condensed from Poor's *Industrials*.

EXHIBIT 3

WALWORTH COMPANY

Net Profit after Interest on Bonds and Debentures,* Years Ended December 31

Year	Net profit	Net loss
1928	$ 413,185	. . .
1929	2,031,840	. . .
1930	163,613	. . .
1931	. . .	$2,062,555
1932	. . .	1,181,573
1933	. . .	681,630
1934	. . .	218,288

* Interest on bonds and debentures was as follows

1928	$653,781	1931	$592,108
1929	605,680	1932	567,870
1930	614,497	1933	558,539
	1934	$553,334	

In 1933 and 1934 interest was accrued but not paid.
Condensed from Poor's *Industrials*.

and common stock. Net earnings of the Walworth Company for the 7-year period, 1928 through 1934, are shown in Exhibit 3; balance sheets for 1930, 1932, and 1934 in Exhibit 4. Further description of the company's securities is given in Exhibit 5.

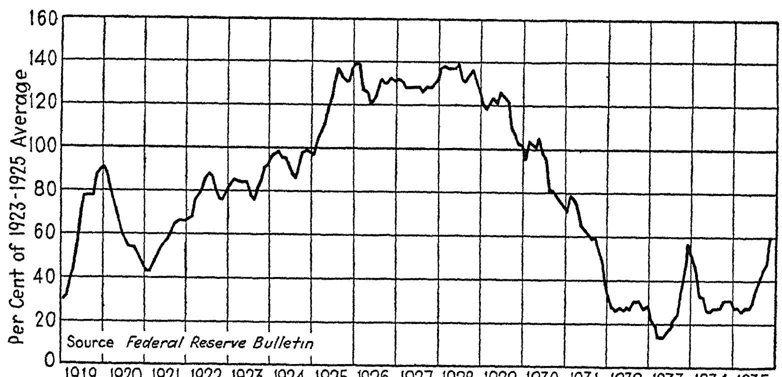

CHART. I.—Index of value of building contracts awarded in thirty-seven eastern states, adjusted for seasonal variation.

Both companies depended to a large extent on the building industry for sales. Chart I indicates the fluctuations in the dollar volume of construction.

1. What items on the balance sheet show the capital structure of the company?

2. What should be the relationship between the capital structure of an industrial company and its average earnings? What

EXHIBIT 4
WALWORTH COMPANY
Consolidated Balance Sheet, as of December 31

	1930	1932	1934
ASSETS			
Land, Plant and Equipment, Less Depreciation	$15,628,467	$14,668,901	$12,983,617
Patents and Goodwill	425,910	1	1
Miscellaneous Securities	232,408	125,789	68,572
Current Assets:			
Cash	1,192,150	442,613	631,809
Marketable Securities at Market Value	....	....	7,025
Drafts and Notes Receivable	286,894	295,498	} 1,016,700
Accounts Receivable (net)	1,958,659	915,165	
Sundry Receivables	21,814	.. .	20,457
Inventories	7,692,678	3,614,059	3,410,105
Total Current Assets	$11,152,195	$ 5,267,335	$ 5,086,096
Notes Receivable (not current)	93,436	116,558	194,902
Leaseholds and Lease Purchase Contracts	149,381	182,380	128,002
Sinking Fund Cash	....	6,389	129,953
Investment in Plug Valve Business Rights, Patents, Patterns, Contracts, etc.	397,118	. .	.. ..
Prepaid Expenses and Deferred Charges	413,445	115,120	97,184
Total Assets	$28,492,360	$20,482,473	$18,688,327
LIABILITIES			
Common Stock	$ 6,929,785*	$ 6,929,785*	$ 7,092,285*
General Surplus	6,838,853	5,035,135	4,446,314†
Earned Surplus since Jan. 1, 1925	1,672,808	4,755,918[d]	6,099,254[d]
Preferred Stock, Par $50	1,000,000	993,000	993,000
Preferred Stock of Subsidiary Company	225,000	225,000	280,125‡
Funded Debt:			
6% First Mortgage Sinking Fund Gold Bonds, Series "A," due 1945	7,456,000	7,141,000	7,141,000
6½% 10-Year Sinking Fund Gold Debentures, Series "A," due Oct. 1, 1935	1,887,000	1,673,500	1,673,000
Bonds of Subsidiaries§	403,200	318,200	207,300
Current Liabilities:			
Notes and Accounts Payable, Including Accruals	1,564,813‖	1,277,987	634,561
Matured Interest on Bonds and Debentures Unpaid	.....	....	1,074,410
Walworth Alabama Company First Mortgage Bonds, due Aug. 1, 1935, less $13,000 owned by Walworth Company	.	. . ..	27,000
Total Current Liabilities	$ 1,564,813‖	$ 1,277,987	$ 1,735,971
Reserve for Contingencies	514,901	444,784	180,420
Special Reserve for Amortization of Plant and Equipment	... . ..	1,200,000	1,038,166
Total Liabilities	$28,492,360	$20,482,473	$18,688,327
Net Working Capital	$ 9,587,382	$ 3,989,348	$ 3,350,125

* Represented by 327,860 shares in 1930 and 1932, and by 357,860 shares in 1934; no-par value.
† Includes earned surplus accrued prior to Jan 1, 1925, $496,545, and surplus arising from appreciation of plant and equipment in 1921 and 1925, $3,949,769.
‡ Includes semiannual dividends accrued thereon amounting to $55,125.
§ Not directly guaranteed by Walworth Company.
‖ Includes reserve for taxes.
[d] Deficit.
Source: Poor's *Industrials*.

effect should the regularity of earnings have on a company's capital structure?

3. How does the reinvestment of earnings affect a company's balance sheet? Illustrate your answer by referring to The Yale & Towne Manufacturing Company.

EXHIBIT 5
WALWORTH COMPANY
Provisions Relating to Securities

1. *First Mortgage Sinking Fund Gold Bonds, Series "A," 6%; Due October* 1, 1945.[1]

Security.—Secured by a first mortgage on the entire fixed property of the company and also by pledge of all the outstanding common stocks of eight subsidiaries

Sinking Fund.—Annual sinking fund is provided for equal to 10% of the consolidated net earnings for the preceding calendar year.

Callability.—Subject to call as a whole or in part at any time on 60 days' notice at 105 and interest up to, but not including, October 1, 1936, and thereafter at 100 and interest, plus a premium of ½% for each year or fraction thereof of unexpired life.

2. *Ten-year 6½% Sinking Fund Gold Debentures, Series "A"; Due October* 1, 1935[1]

Security.—A direct obligation of the company issued under an indenture which provides that no further mortgage is to be created by the company upon the properties securing the First Mortgage (except mortgages to refund First Mortgage Bonds, purchase money bonds, etc.) without including these Debentures equally and ratably therewith.

Sinking Fund.—Annual sinking fund, applicable to the entire $5,000,000 authorized, is provided for equal to 5% of the preceding fiscal year's net earnings, the first payment to be made on April 1, 1927.

Callability.—Subject to call as a whole or in part at any time on 60 days' notice at 105 and interest on or before October 1, 1926; the premium to decrease ½% for each 12 months or part thereof elapsed thereafter to maturity.

3. *Preferred Stock.*

Preferred stock has preference as to assets and dividends and in case of liquidation or distribution of its assets is entitled to par and accrued dividends It has no voting power unless for a period of 36 consecutive months the aggregate dividends paid thereon shall not amount to 18%, or an average of 6% for 3 years; in this event it assumes exclusive voting power and retains the same so long as any dividends are in arrears.

Preferred stock is subject to redemption as a whole or in part at $55 and accrued dividends on any dividend date on 60 days' notice.

[1] Interest due April 1, 1933, and subsequently is in default.
Condensed from Poor's *Industrials*.

4. What is the difference between first mortgage and debenture bonds?

5. Is there any difference in the obligations of a company to its cumulative preferred stockholders and to its first mortgage bondholders?

6. Explain the difference between common stock having a par value, such as that of The Yale & Towne Manufacturing Company, and common stock having no par value, such as that of the Walworth Company.

2. ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY[1]

CAPITAL STRUCTURE OF A RAILWAY COMPANY

In 1935 the Atchison, Topeka and Santa Fe Railway Company, which was incorporated in Kansas in 1895, comprised a system ranking second in mileage and fifth in gross revenue among railroads of the United States. Its predecessor, the Atchison, Topeka and Santa Fe Railroad Company, had received a charter in Kansas in 1859, but was not opened for traffic until the depression of 1873. Twenty-two years of indifferent success culminated in a foreclosure sale to the present company.

Since the reorganization of 1895 the Atchison, Topeka and Santa Fe Railway Company had expanded by building branch lines and by acquiring tributary roads only as the needs of the area grew. Some 2,000 miles of track were added between 1918 and 1932 in the rapidly developing Southwest. The company's transcontinental lines from Chicago to Galveston and to the

EXHIBIT 1
ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY
Classification of Tonnage and Revenue

Commodities	1929		1934	
	Per cent of total tonnage	Per cent of total revenues*	Per cent of total tonnage	Per cent of total revenues*
Wheat	8 8	7 5	9 1	5 8
Oranges and grapefruit	1 3	5 8	1.9	8 1
Grapes (fresh)	0.7	3 5	0 7	2.9
Other agricultural products	12.0	13 0	13 6	14 3
Total products of agriculture	22 8	29 8	25 3	31 1
Animals and products	3 2	5 3	5 7	9 2
Products of mines	36 0	10 0	28 4	7.9
Petroleum oils, refined	10 9	10 4	14 4	11 3
Other manufactures and miscellaneous	19 2	28 1	20 2	28.2
Products of forests	5 3	4 0	3 9	2 7
All less-than-carload lots	2 6	12 4	2 1	9 6
Totals, per cent	100 0	100 0	100 0	100 0
Totals, actual	50,948,781 tons	$210,266,912	26,993,999 tons	$109,228,176

* "Gross revenues without adjustment for absorptions or corrections."
Derived from company reports, 1929 and 1934, and Moody's *Railroads*.

[1] See Appendix I, "Analysis of Financial Statements," p. 345.

Pacific coast through the southern route were supported by a vast network of feeder lines. The many products shipped to and from this territory and the traffic on the trunk line provided diversified sources of revenue (see Exhibits 1 and 3). In 1929 considerable

EXHIBIT 2

ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY

Condensed General Balance Sheet, as of December 31, 1929, 1932, and 1934

	1929	1932	1934
ASSETS			
Road and Equipment	$1,094,701,875	$1,155,759,628	$1,138,404,239
Miscellaneous Physical Property	9,176,632	10,666,584	16,683,433
Investments in Terminal and Collateral Companies	25,248,383	28,092,744	30,372,271
Other Investments	48,892,022	23,939,251	2,987,165
U.S. Government Securities	....	....	24,703,874
Current Assets:			
Cash and Time Deposits	38,603,164	22,489,243	29,114,439
Special Deposits	74,939	21,823	1,258,003
Agents and Conductors	1,341,075	646,548	832,962
Traffic and Car Service Balances Receivable	3,019,408	2,224,137	1,580,923
Other Receivables	9,301,367	3,508,064	5,419,486
Material and Supplies	29,731,383	18,871,506	17,634,095
Other Current Assets	99,772	35,853	34,054
Total Current Assets	$ 82,171,108	$ 47,797,174	$ 55,873,962
Deferred Assets	381,891	438,902	1,333,293
Unadjusted Debits	1,919,893	1,484,050	1,624,445
Total Assets	$1,262,491,804	$1,268,178,333	$1,271,982,682
LIABILITIES			
Common Stock, $100 Par	$ 241,629,300	$ 242,706,000	$ 242,706,000
Preferred Stock, $100 Par	124,172,800	124,172,800	124,172,800
Funded Debt	311,575,201	309,672,262	309,660,262*
Current Liabilities:			
Traffic and Car Service, Balances Payable	1,610,464	702,081	716,403
Accounts and Wages Payable	18,392,661	7,696,548	9,840,260
Interest and Dividends Matured and Unpaid	1,081,428	1,055,233	1,061,759
Unmatured Dividends Declared	9,145,053	3,104,320	3,104,320
Unmatured Interest and Rents Accrued	3,503,428	3,467,206	3,443,920
Other Current Liabilities	1,211,169	339,090	389,624
Total Current Liabilities	$ 34,944,203	$ 16,364,478	$ 18,556,286
Tax Liability	13,532,893	6,514,216	3,392,837
Accrued Depreciation—Road and Equipment	125,877,659	158,432,684	176,191,801
Deferred Liabilities	3,043,951	2,715,873	2,294,656
Unadjusted Credits	4,960,937	3,424,659	2,817,169
Corporate Surplus and Premium	88,294,502	89,646,852	89,724,525
Profit and Loss Balance	314,460,358	314,528,509	302,466,346
Total Liabilities	$1,262,491,804	$1,268,178,333	$1,271,982,682

* See Exhibit 4.
Condensed from company reports.

cut-offs for transcontinental freight and an access to additional markets were obtained by the acquisition of the Kansas City, Mexico, and Orient lines.

The Interstate Commerce Commission for the purpose of setting rates valued the properties of the railroad at $584,293,419, as of June 30, 1916. This value included an estimate for working capital of $15,731,240 but did not include any allowance for

EXHIBIT 3
ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY
Condensed Income Account, Years Ended December 31, 1929, 1932, and 1934

	1929	1932	1934
Freight revenue	$204,551,492	$107,400,213	$104,720,630
Passenger revenue	37,926,205	14,520,806	11,970,642
Other operating revenue	24,711,481	11,212,519	11,402,676
Total operating revenue	$267,189,178	$133,133,538	$128,093,948
Maintenance of way and structures	$ 42,175,627	$ 15,342,514	$ 16,537,881
Maintenance of equipment	48,439,077	31,536,604	30,843,588
Railway tax accruals	20,340,961	12,824,970	10,352,828
Other operating expenses	87,581,182	55,769,657	55,130,333
Railway operating expenses	$198,536,847	$115,473,745	$112,864,630
Railway operating income	$ 68,652,331	$ 17,659,793	$ 15,229,318
Other income	5,827,914	3,239,959	4,950,533
Total income	$ 74,480,245	$ 20,899,752	$ 20,179,851
Rentals	$ 115,018	$ 155,979	$ 41,953
Interest on funded debt	12,766,878	12,804,313	12,803,367
Interest on unfunded debt	266,497	166,904	125,972
Other income deductions	295,049	227,549	207,245
Total income deductions	$ 13,443,442	$ 13,354,745	$ 13,178,537
Net profit	$ 61,036,803	$ 7,545,007	$ 7,001,314
Preferred dividends	$ 6,208,640	$ 6,208,640	$ 6,208,640
Common dividends	24,162,930	2,427,060	4,854,120
Times interest earned	5 54	1.56	1.53
Times interest and preferred dividend requirements earned	3 78	1 07	1.04
Earnings per share of common stock	$ 22 69	$ 0 54	$ 0.32

Condensed from company reports.

"noncarrier" properties such as the coal, oil, and lumber holdings of the system. Between June 30, 1916, and December 31, 1934, the system invested $439,891,159 in net additions and extensions so that the value set by the Interstate Commerce Commission

was $1,024,184,578, as of December 31, 1934. Balance sheets as of December 31, 1929, 1932, and 1934 are shown in Exhibit 2.

Much of the financing after the reorganization in 1895 was done by means of convertible bond issues. The conversion privileges were widely exercised. All the provisions for conversion of bond issues had expired by 1923 except those of the 4½% debentures due in 1948 (see Exhibit 5). A conservative dividend policy during years of liberal earnings allowed a large

EXHIBIT 4
ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY
Funded Debt, as of December 31, 1934

Class of bonds	Date issued	Date due	Rate of interest %	Amount authorized	Amount outstanding
General mortgage*	Dec. 12, 1895	Oct. 1, 1995	4	$155,942,500	$151,934,500
Adjustment mortgage*	Dec. 12, 1895	July 1, 1995	4	51,728,000	51,346,000
Convertible	Feb. 9, 1905; June 1, 1909	June 1, 1955	4	84,711,000	7,975,000
Convertible	Jan. 1, 1910	June 1, 1960	4	43,686,000	526,000
Convertible debenture*	Dec. 1, 1928	Dec. 1, 1948	4½	30,204,000	28,070,500
Transcontinental Short Line	July 1, 1908	July 1, 1958	4	27,808,000	22,545,000
California-Arizona Lines	Mar. 1, 1912	Mar. 1, 1962	4½	33,235,000	33,216,262
Rocky Mountain Division	Jan. 1, 1915	Jan. 1, 1965	4	3,000,000	3,000,000
San Francisco and San Joaquin Valley Railway	Oct. 1, 1896	Oct. 1, 1940	5	6,000,000	5,547,000
Santa Fe, Prescott and Phoenix Railway	Sept. 1, 1892	Sept. 1, 1942	5	4,940,000	4,940,000
Chicago, Santa Fe and California Railway	Jan. 1, 1887	Jan. 1, 1937	5	†	560,000
Total funded debt outstanding as of Dec. 31, 1934.					$309,660,262

* See Exhibit 5
† $35,000 mortgage limitation per mile of road.
Compiled from company reports and Moody's *Railroads*.

reinvestment of funds in equipment and construction so that securing funds for such purposes by means of new securities was not necessary. Exhibit 4 summarizes the funded debt of the Atchison, Topeka and Santa Fe Railway Company as of December 31, 1934, and Exhibit 5 gives a brief description of selected bond issues.

In 1933 on the occasion of Mr. W. B. Storey's retirement from the presidency of the Atchison, Topeka and Santa Fe Railway

Company after he had been associated with the system since 1895, the press commended his technical development of the

EXHIBIT 5
ATCHISON, TOPEKA AND SANTA FE RAILWAY COMPANY
Brief Description of Selected Bond Issues

1. *Atchison, Topeka and Santa Fe Railway Company, general gold 4s, due 1995:*
Dated.—December 12, 1895.
Callable.—Not subject to call.
Sinking Fund.—No provision for sinking fund.
Security.—Direct lien on 7,030.93 miles of track, being a first lien on 5,731.70 miles and a second lien on 1,299.23 miles. Collateral lien on 1,420 48 miles of track through pledge of bonds and capital stock of railways and terminal companies; these securities had par value of $76,235,900. In addition, secured by 1,665 locomotives, 1,506 passenger cars, 87,357 freight cars, 4,133 miscellaneous cars and 8 pieces of floating equipment. This issue plus prior liens constituted a debt of $21,275 per mile of road covered by the mortgage.

2. *Atchison, Topeka and Santa Fe Railway Company, adjustment gold 4s, due 1995:*
Dated.—December 12, 1895.
Payable —Interest payable only when earned.
Callable.—Not subject to call.
Sinking Fund.—No provision for sinking fund.
Security.—Second and third lien on 7,030 93 miles of track, second collateral lien on 1,420.28 miles of track and second collateral lien on miscellaneous securities. This issue plus prior liens constituted a debt of $27,325 per mile of road covered by the mortgage.

3. *Atchison, Topeka and Santa Fe Railway Company, convertible debenture gold 4½s, due 1948:*
Dated.—December 1, 1928.
Convertible.—At any time on or after December 1, 1930, and prior to December 1, 1938, into common stock in ratio of 6 shares of common stock for each $1,000 bond; adjustment of conversion price to be made in event of stock dividend.
Callable.—As a whole on any interest date after December 1, 1938, and prior to December 1, 1948, at 102 on 3 months' notice
Sinking Fund.—No provision for sinking fund.
Security.—A direct obligation of company but not secured by mortgage.

4 *Atchison, Topeka and Santa Fe Railway Company, Transcontinental Short Line 1st gold 4s, due 1958.*
Dated.—July 1, 1908.
Callable.—Callable at 110 and interest on any interest date on three months' notice.
Security.—Mortgage covers all present lines and branches and those hereafter acquired by Eastern Railway Company of New Mexico. Mortgage also covers the $11,984,000 1st mortgage 6s, $9,000,000 general mortgage 6s, and all but 7 shares of the capital stock of the Pecos and Northern Texas Railway Company and all but 12 shares of the capital stock of the Pecos River Railroad Company. This mortgage underlies the general and adjustment mortgages on the main line across most of New Mexico. Bonds of this issue were outstanding at the rate of $20,220 per mile covered.
Guaranty.—Principal and interest guaranteed by Atchison, Topeka and Santa Fe Railway Company.

Condensed from Moody's *Railroads*, and Fitch's *Bond Book*.

railroad and his influence in having kept the fixed charges moderate. The *Annual Report* to stockholders for 1933 states,

"Neither your company nor any of its affiliated railway companies has any notes or bills outstanding, and your company during the depression has not borrowed any money from any source whatsoever or deferred the payment of any of its bills."

1. In estimating the security of bonds, what is the relative significance of earnings, extent and location of property, and legal priority of claims?

2. What other factors affect the price or yield of bonds? Is the noncallable feature of any significance to investors and to the company?

3. Contrast mortgage and debenture bonds.

EXHIBIT 6

COMPARATIVE CAPITALIZATIONS OF A RAILROAD, A PUBLIC UTILITY, AND AN INDUSTRIAL COMPANY

Capitalization as of Dec. 31, 1934	Atchison, Topeka and Santa Fe Railway Company		Consolidated Gas Electric Light and Power Company of Baltimore		The Yale & Towne Manufacturing Company	
	Amount	Per cent of total	Amount	Per cent of total	Amount	Per cent of total
Mortgage bonds	$ 273,087,762	25 6	$ 67,390,500	48 3	......	...
Debentures	36,572,500	3 4	.....		......	...
Preferred stock	124,172,800	11 6	22,430,800	16 1	......	...
Common stock	242,706,000	22 7	39,414,813	28 2	$12,166,400	74 0
Surplus	392,190,871	36.7	10,197,548	7 4	4,274,942	26 0
Total capitalization	$1,068,729,933	100.0	$139,433,661	100 0	$16,441,342	100 0

Compiled from company reports.

4. What is the full significance of a convertible bond in the capital structure of a railroad company?

5. Should railroads attempt to reduce their bonded indebtedness?

6. Contrast the earnings of the Atchison, Topeka and Santa Fe Railway with those of the Consolidated Gas Electric Light and Power Company of Baltimore (see page 39) and of the Walworth Company (see page 28).

7. Discuss the relationship between the earnings and the capital structure (see Exhibit 6) in industrials, in public utilities, and in railroads.

8. What do adjustment bonds generally signify? What is the rating of adjustment bonds of this railroad? Why?

3. CONSOLIDATED GAS ELECTRIC LIGHT AND POWER COMPANY OF BALTIMORE

CAPITALIZATION OF A PUBLIC UTILITY COMPANY

The Consolidated Gas Electric Light and Power Company of Baltimore, incorporated in Maryland in 1906, was a consolidation of the gas and electric properties in and around Baltimore. The company from time to time had acquired all or a part of the properties and businesses of a number of other companies, some of which were previously subsidiaries. This company, however, was always one of the so-called independent operating units as contrasted with an operating unit of one of the large holding companies.

The company engaged without competition in the gas, electric light, and power business in Baltimore and in the adjacent territory. In addition to supplying electricity and gas to meet all the requirements of the population in this district, the company had contracts to supply power to industrial companies and to the Pennsylvania Railroad for its electrified system from New York to Washington.

The company's franchises for both gas and electricity were unlimited as to time in all the territories served except Annapolis, where the gas franchise would expire in 1963. Although these franchises were not exclusive, no other company could enter these territories as a competitor without the approval of the Public Service Commission of Maryland. These franchises did not fix the return to the company or the rates to be charged for service. Rates were regulated by the Public Service Commission of Maryland.

The Consolidated Gas Electric Light and Power Company of Baltimore owned modern steam generating plants and power stations which had a total capacity of 300,000 horsepower. To supplement this output the company had long-term agreements which gave the Consolidated Gas Electric Light and Power Company of Baltimore an option to purchase electricity as needed from certain corporations which controlled power developments on the Susquehanna River.

EXHIBIT I

CONSOLIDATED GAS ELECTRIC LIGHT AND POWER COMPANY OF BALTIMORE

Consolidated Balance Sheet, as of December 31

	1930	1931	1932	1933	1934
ASSETS					
Cash	$ 3,796,259	$ 6,077,364	$ 4,747,100	$ 4,004,870	$ 3,400,039
Receivables	5,255,436	5,016,004	4,817,532	4,477,957	4,733,708
Marketable Securities	1,828,345	144,009	43,907	... .	.... ..
Materials and Supplies	2,652,180	2,455,990	2,243,594	2,082,972	2,398,032
Miscellaneous Current Assets	2,408,953	2,316,178	2,169,120	2,040,728	2,482,778
Total Current Assets	$ 15,941,173	$ 16,009,545	$ 14,021,253	$ 12,606,527	$ 13,014,557
Fixed Capital	121,965,213	125,913,628	126,973,240	132,104,725	133,108,538
Investments and Advances to Affiliates	6,015,000	2,633,910	4,043,310	6,000,000	6,000,000
Miscellaneous Investments	8,089,034	8,215,247	6,141,998	3,489,004	3,674,526
Other Notes Receivable	....	.	.....	....	1,195,226
Unamortized Discount and Expenses on Bonds	386,597	2,629,635*	....	303,583	1,532,876
Sinking Funds	50,394	50,228	50,232	80,524	80,163
Prepayments and Deferred Charges	425,387	855,009	1,075,332	600,989	1,676,088
Withheld Deposits in Closed or Reorganized Banks	. . .			1,311,872	1,104,407
Total Assets	$152,872,798	$156,307,202	$152,305,365	$156,497,224	$161,386,381
LIABILITIES					
Accounts Payable	$ 762,178	$ 613,416	$ 717,863	$ 914,967	$ 800,015
Consumers' Deposits	57,328	71,077	69,883	91,022	91,351
Matured Interest Unpaid	578,260	586,424	574,398	608,427	268,599
Dividends Declared	1,327,111	1,334,763	1,338,430	1,340,538	1,340,730
Taxes Accrued	1,326,526	1,281,619	1,224,039	1,151,189	1,779,521
Interest Accrued	386,916	374,670	367,243	308,545	730,214
Miscellaneous Current and Accrued Liabilities	209,021	265,693	126,190	2,061,318	748,871
Total Current and Accrued Liabilities	$ 4,647,340	$ 4,527,662	$ 4,418,046	$ 6,476,006	$ 5,759,301
Funded Debt	61,816,500	63,627,500	63,198,000	64,420,400	67,390,500†
Preferred Stock, Par $100	21,541,600	21,993,800	22,263,200	22,415,600	22,430,800
Common Stock‡	39,247,443	39,397,683	39,414,812	39,414,812	39,414,813
Capital Stock Premium and Stock Subscribed	588,025	517,261	249,798	199,299	183,197
Retirement Reserve	7,516,402	7,978,271	8,921,824	10,382,015	11,597,922
Contributions for Extensions	599,463	652,193	696,040	724,382	753,755
Reserve for Doubtful Assets and Contingencies	866,056	866,055	866,056	738,379	2,603,002
Miscellaneous Reserves	750,575	502,893	626,709	580,563	811,834
Miscellaneous Unadjusted Credits	496,839	432,576	350,887	381,100	426,905
Surplus	14,802,555	15,811,308	11,299,993	10,764,668	10,014,351
Total Liabilities	$152,872,798	$156,307,202	$152,305,365	$156,497,224	$161,386,381

* Includes premium and expense paid to retire Series "F" 5s in 1931 for which 4 % bonds were substituted.

† Not including $13,803,000 bonds maturing Feb. 14, 1935, and $795,400 bonds called for redemption June 1, 1935, against which funds had been deposited with the Trustee.

‡ Represented by no-par shares: 1,164,897 in 1930; 1,167,137 in 1931; 1,167,397 in 1932, 1933, 1934.

Note: $21,000,000 First Mortgage Sinking Fund Gold Bonds, Series due 1979, of Safe Harbor Water Power Corporation, guaranteed as to principal and interest by company.

Source: Moody's *Public Utilities*.

EXHIBIT 2

CONSOLIDATED GAS ELECTRIC LIGHT AND POWER COMPANY OF BALTIMORE

Consolidated Income Account, Years Ended December 31

	1930	1931	1932	1933	1934
Total operating revenue	$28,582,423*	$28,499,248	$27,506,531	$27,465,445*	$28,953,281*
Operating expenses	14,322,085	13,702,518†	13,334,263†	13,071,091†	14,411,985†
Retirement expense	2,074,525	2,181,189	2,270,418	2,385,842	2,409,680
Taxes	2,922,053	2,963,383	3,110,526	3,491,183	3,571,805
Total operating revenue deductions	$19,318,663	$18,847,090	$18,715,207	$18,948,116	$20,393,470
Net operating revenue	9,263,760	9,652,158	8,791,324	8,517,329	8,559,811
Miscellaneous nonoperating revenue	776,604	575,569	262,297	152,342	200,017
Total income	$10,040,364	$10,227,727	$ 9,053,621	$ 8,669,671	$ 8,759,828
Bond interest	2,757,363	2,982,292	2,848,629	2,891,875	2,828,400
Other interest, amortization, and fixed charges	20,383	47,951	52,437	60,700	54,109
Total deductions	$ 2,777,746	$ 3,030,243	$ 2,901,066	$ 2,952,575	$ 2,882,509
Net income	7,262,618	7,197,484	6,152,555	5,717,096	5,877,319
Preferred dividends	1,110,260	1,123,407	1,145,868	1,157,447	1,158,927
Common dividends	4,082,973	4,198,896	4,202,459	4,202,629	4,202,577
Balance	$ 2,069,385	$ 1,875,181	$ 804,228	$ 357,020	$ 515,815
Net deductions from surplus‡	623,841	866,428	5,315,544	892,346	1,266,131
Net decrease in surplus	$ 1,445,544§	$ 1,008,753§	$ 4,511,316	$ 535,326	$ 750,316
Times fixed charges earned, over-all	3 61	3 38	3 12	2 94	3 04
Times fixed charges and all preferred dividends earned, over-all	2 58	2 46	2 24	2 11	2 17
Earnings per common share‖	$ 5 42	$ 5 21	$ 4 29	$ 3 91	$ 4 04

* Reduced rates effective in November, 1929, and at different times in 1933 and 1934

† 1934 includes $114,350, and 1933 includes $217,252 credited to Hydro-equalization account due to higher than normal usual flow of the Susquehanna River and the resultant increase in hydro-electric power generated; 1932 and 1931 do not include charges of $77,174 and $613,874 respectively to such account to compensate for the subnormal usable river flow. This account was established as of January, 1931, in order to avoid fluctuations in operating expenses from period to period consequent upon river flow and was a result of the new long-term power contracts entered into in 1931.

‡ Includes sundry additions to and deductions from surplus, the net result of miscellaneous charges and credits applicable to prior years and the following 1932 includes $2,590,924 write-off of all unamortized discount, premium, and expense incurred in the issuance and retirement of bonds of the company, and $2,508,087 representing a complete adjustment to existing conditions and values of certain securities, accounts, and properties owned by the company. 1933 includes $215,979 premium and expense incurred in the retirement, during 1933, of series E 5½ % first refunding mortgage bonds, for which 4 % bonds were substituted, thus producing an annual interest saving; and $556,668 estimated net loss resulting from impairment of banks.

§ Net increase in surplus

‖ Based on average number of shares outstanding during year.

Condensed from Moody's *Public Utilities.*

The steady growth of this company is shown not only in the balance sheets and operating statements which are given in Exhibits 1 and 2 but also by the statistics given in Exhibit 3. A

EXHIBIT 3
CONSOLIDATED GAS ELECTRIC LIGHT AND POWER COMPANY OF BALTIMORE
Operating Statistics, Years Ended December 31

Year	Electricity			Gas		
	Number of customers	Sales (Kw.-hours)	Sales (Dollar volume)	Number of customers	Sales (M. cu ft.)	Sales (Dollar volume)
1925	158,608	645,215,639	$14,191,571	175,075	10,372,886	$8,387,771
1926	174,423	727,475,746	15,312,939*	184,036	11,376,915	9,169,143
1927	188,888	703,379,370	15,470,873*	188,273	11,177,310	9,043,432
1928	201,983	738,033,805	16,488,153	191,069	11,531,294	9,272,736
1929	214,640	814,194,456	17,803,343*	196,515	12,161,852	9,502,208*
1930	221,567	830,563,939	18,370,668*	198,879	12,203,883	9,326,980*
1931	223,218	783,635,924	18,454,778	197,725	11,822,080	9,136,248
1932	222,183	758,654,047	17,754,957	194,238	11,255,949	8,769,276
1933	241,114	800,260,688	17,954,966	197,877	11,026,176	8,592,809
1934	248,898	890,523,724	19,041,378	202,622	11,748,511	8,876,357

* Giving effect to rate reductions.
Compiled from Moody's *Public Utilities*.

brief description of selected bond issues and of the capital stock is presented in Exhibit 4 to supplement the information given in the balance sheet.[1]

1. Differentiate between a "public utility" and an "industrial."
2. Contrast the earnings record of this company with those of The Yale & Towne Manufacturing Company and of the Walworth Company.
3. Does the difference in earnings indicate that the capital structure of a utility might differ from that of an industrial?
4. What rights does a franchise give a utility? Are franchises significant today?
5. What were the total fixed charges in 1934?
6. What is the meaning of "serial" preferred stock and bonds?
7. Discuss the meaning of the following terms: (*a*) a closed mortgage, (*b*) subject to call, (*c*) multiple voting right of preferred stock, (*d*) sinking fund, and (*e*) series A preferred stock.

[1] See Exhibit 6, p. 36, Atchison, Topeka and Santa Fe Railway Company case, for comparative capital structure.

EXHIBIT 4
CONSOLIDATED GAS ELECTRIC LIGHT AND POWER COMPANY OF BALTIMORE
Condensed Description of Selected Bond Issues, Preferred Stock and Common Stock
Outstanding as of December 31, 1934

1. *Consolidated Gas Company of Baltimore City, consolidated first gold 5s, due 1939:*

Closed mortgage.—Outstanding, $3,400,000.

Dated.—July 1, 1889; due July 1, 1939.

Assumed.—Payment of principal and interest assumed by Consolidated Gas Electric Light and Power Company of Baltimore.

Callable.—Not subject to call.

Security.—First (closed) mortgage upon entire property owned by former The Consolidated Gas Company of Baltimore City.

2. *Consolidated Gas Electric Light and Power Company of Baltimore, first refunding sinking fund gold 4s, series due 1981:*

Authorized.—All series, $100,000,000; outstanding, series due 1981, $22,455,000.

Dated.—June 1, 1931; due June 1, 1981.

Callable—As a whole or in part at any time on 60 days' notice at 105 to June 1, 1936, inclusive, at 1% less each of two 5-year periods thereafter, at ½% less each 5 years through June 1, 1966, at 100½ through June 1, 1976, and at 100 thereafter, with accrued interest in each case.

Sinking Fund.—Payable annually, on August 1, an amount equal to 1% of the largest amount of first refunding mortgage bonds of all series outstanding during the year ending August 1. (First payment made August 1, 1932.) Such funds to be used for the purchase or redemption (by lot) of bonds of all series at not exceeding the call price.

Security.—Secured equally with $18,000,000 series K 3¾s, $10,440,000 series L 3¾s, and $7,326,000 series M 3½s, by a first mortgage on all of the company's properties now owned or hereafter acquired, subject, as to their respective properties, to the prior liens of $105,000 Roland Park Electric and Water Company 1st 5s of 1937, $3,400,000 The Consolidated Gas Company of Baltimore consolidated 1st gold 5s of 1939, and $6,100,000 The Consolidated Gas Company of Baltimore City general 4½s of 1954.

3. *Consolidated Gas Electric Light and Power Company of Baltimore 5% cumulative preferred stock, series A:*

Authorized.—All series, $50,000,000. Authorized, series A, $45,000,000; outstanding, March 31, 1935, $17,431,800; par $100.

Preferences.—Has preference as to assets and dividends concurrently with series D and E. In any liquidation entitled to par and dividends.

Callable—As a whole or in part at any time on 60 days' written notice at 110 and accrued dividends. All preferred redeemed shall have the status of authorized but unissued preferred stock.

Other Provisions.—Authorized but unissued preferred stock may, after proper amendments to the charter, be issued in series with different dividend rates, and with different provisions for participation, conversion, and redemption. Common stock has sole voting power except as follows:

1. Preferred shares shall have four votes and common shares one vote on proposed charter amendments (other than those referred to above) on any proposed consolidation, sale, lease, exchange, or dissolution of the company's property, goodwill, or franchise. Such an amendment must be passed by affirmative vote of ⅔ of all preferred shares outstanding.
2. Failure of dividend payments for one year shall give preferred shares full voting power till the averages are made up.

Majority of votes must be of aggregate number of votes to which all outstanding shares shall be entitled. Aggregate number of shares of preferred shall at no time

EXHIBIT 5 (*Continued*)

exceed 1/4 the total amount of common stock issued and outstanding with the public, nor shall the amount of common stock publicly outstanding be reduced either by purchase or charter amendment below 4 times the total amount of preferred outstanding. No preferred stock shall be issued unless earnings applicable to preferred dividends in the 12 months ending within the 60 days immediately preceding the issuance shall have been at least twice the preferential dividend requirements of all preferred stock outstanding and presently to be issued.

4. *Consolidated Gas Electric Light and Power Company of Baltimore common stock:*
Authorized—2,000,000 shares; outstanding, March 31, 1935, 1,167,397 shares; no par.
Sole voting power rests with holders of common stock, except as noted under preferred stock provisions.

Condensed from Moody's *Public Utilities*.

4. GUARANTY TRUST COMPANY OF NEW YORK

CAPITALIZATION OF A BANK

The capitalization of banks is somewhat different from the capitalization of industrial companies, utilities, and railroads. The difference exists chiefly because of the specialized business of banks. As a rule banks do not publish detailed financial statements. During recent years numerous changes have occurred in our banking laws which have affected not only the capitalization of banks and the relationship between the banks and the holders of their stocks, but also the very character of banking business itself.

The Banking Act of 1935 removed from stockholders of national banks the double-liability feature which had existed previously and instead required that the surplus be increased to equal the capital. The act also created a Federal Deposit Insurance Corporation which would insure individual bank deposits up to $5,000, for an assessment of 1/12 of 1% per annum of total net deposits. Under the same act the Board of Governors of the Federal Reserve System was given new power to control credit, including the power of doubling the cash reserves required of member banks.

Certain problems common to many banks in January, 1936, are discussed briefly in the report to stockholders for 1935 issued by the Guaranty Trust Company of New York. The following material is reprinted from this report:

GUARANTY TRUST COMPANY OF NEW YORK
140 Broadway
New York

January 15, 1936

To the Stockholders of the Guaranty Trust Company of New York:

The earnings of your Company for the year 1935, as compared with those of the preceding year, are presented herewith:

	1935	1934
The earnings of the Company were	$ 12,795,875	$ 20,992,304
Out of which were paid dividends of	10,800,000	18,000,000
Leaving	$ 1,995,875	$ 2,992,304
During the period there was set aside as reserves, or for miscellaneous charge-offs, including payments in connection with Deposit Insurance Fund	1,892,183	3,683,220
Resulting in a		
Credit to Undivided Profits of	$ 103,692	
Debit to Undivided Profits of		$ 690,916
During 1935 nonrecurring profits were realized of	$ 4,812,485	..
Of this amount there was transferred to Current Earnings, and included above, the sum of	2,375,041	...
Leaving unused balance on December 31, 1935, of	$ 2,437,444	
Average net deposits	$1,303,318,000	$1,092,228,000

This comparison shows with graphic emphasis the effect of a combination of increased bank deposits and curtailed use of them by commerce, industry, and agriculture. These circumstances have resulted in the accumulation of surplus reserves by member banks estimated at $2,850,000,000 on December 31 last. So long as such conditions continue to exist, bank earnings are obviously certain to remain at low levels. The underlying causes for this condition have been described so frequently that I shall not attempt to discuss them here. Excess reserves have been mounting throughout the year, reaching their peak for the time being in the month of December. At the present time, there is no indication of any decided change in the demand for bank credit. Nevertheless, a change may readily take place in these conditions, through the reexport of gold to countries from which it has recently come; from a return of confidence and a continued improvement in business; from Federal Reserve action, which has been much discussed recently; from the retirement of government from the field of banking and private finance; and from a balanced government budget and a decline in government debt.

The Banking Act of 1935 was finally passed in August, after much debate between those forces which contended for and against the political control of the country's banking system. The resulting act leaves much to be desired, but it nevertheless represents a decided improvement over the form in which it was originally introduced.

The act includes a provision for the so-called guaranty of bank deposits, which we have referred to before as being unsound, and particularly unfair to such institutions as yours. It provides for a limited annual assessment upon all members of the Federal Reserve

System amounting to 1/12 of 1% of total deposits. These assessments are paid to the Federal Deposit Insurance Corporation, which administers the resulting fund for the benefit of a certain special class of depositors of banks which fail. This section of the act is an improvement over the corresponding section of the Banking Act of 1933 in one important respect, in that the maximum assessment which may be levied is fixed at 1/12 of 1%, whereas the 1933 law provided for the power to make unlimited assessments.

Since Congress has seen fit to put the guaranty of bank deposits into the Banking Law, it leaves to us the alternatives of accepting it and working under it or withdrawing from the Federal Reserve System. After the most careful consideration by your management, it was decided to adopt the former course, primarily because, under existing circumstances, it is not clear that an institution of our size and character could render to our clients and the public as good service outside the Federal Reserve System as within it.

. . . . . .

The most important factors in determining the course of the money market during 1935 were the retention by the Federal Reserve banks of almost a fixed amount of $2,430,000,000 government securities, the importation of a net amount of $1,729,000,000 of gold, and the acquisition by the Treasury to December 6 last of 479,264,000 ounces of silver, as well as the refunding operations conducted by the Treasury amounting to approximately $9,000,000,000, and the issue of new government securities of approximately $3,500,000,000, which resulted in a net increase in the interest-bearing debt (direct obligations) of $1,652,000,000. The year closed with an interest-bearing government debt, including fully guaranteed obligations, of approximately $34,000,000,000.

Accurate figures as of December 31 are not available, but on June 29 last the insured commercial banks held approximately 40% of the outstanding direct and fully guaranteed obligations of the government. To put the situation in another manner, this group of banks had on June 29 invested in direct and fully guaranteed obligations of the government their entire capital, surplus and undivided profits, and $6,568,000,000 of their deposits. The increased holdings of government securities by this same group of banks during the fiscal year ended on that date amounted to about $2,000,000,000, which very materially contributed to the marked increase of $3,468,000 in bank deposits (exclusive of interbank deposits) during this period.

If peace can be maintained, and if narrow nationalism, futile class struggles, and unsound political interference with business can be held in check, it is reasonable to believe that 1936 will bring further progress toward recovery. To the extent that these hopes can be realized, the very unusual credit conditions that have reduced bank earnings to such low levels during the past year will tend to give way to a more normal situation, in which both the demand for bank credit

and the level of money rates will be more satisfactory from the standpoint of earnings.

. . . .

(signed) William C. Potter
Chairman of the Board

The balance sheet of the Guaranty Trust Company of New York, included in the 1935 annual report, is presented as Exhibit 1.

Exhibit 1
Guaranty Trust Company of New York
Condensed Statement, December 31, 1935

Resources		
Cash on Hand, in Federal Reserve Bank, and Due from Banks and Bankers		$ 620,600,525 90
Bullion Abroad and in Transit		14,960,217 00
U.S. Government Obligations		474,466,017 17
Public Securities		49,281,788 62
Stock of the Federal Reserve Bank		7,800,000 00
Other Securities		23,825,671 21
Loans and Bills Purchased		592,238,793 76
Items in Transit with Foreign Branches		2,112,677 12
Credits Granted on Acceptances		37,352,025 40
Bank Buildings		13,547,352 39
Other Real Estate		337,581 50
Real Estate Bonds and Mortgages		2,990,698.74
Accrued Interest and Accounts Receivable		7,920,513.65
		$1,847,433,862 46
Liabilities		
Capital	$ 90,000,000 00	
Surplus Fund	170,000,000 00	
Undivided Profits	7,398,411 72	
		$ 267,398,411 72
Dividend Payable January 2, 1936		2,700,000 00
Accrued Interest, Miscellaneous Accounts Payable, Accrued Taxes, etc.		15,076,421.38
Acceptances	$ 71,334,590.24	
Less: Own Acceptances Held for Investment	33,982,564 84	
		37,352,025 40
Liability as Endorser on Acceptances and Foreign Bills		8,840,400 00
Agreements to Repurchase Securities Sold		2,135,441 00
Deposits	$1,485,303,641 18	
Outstanding Checks	28,627,521 78	
		1,513,931,162 96
		$1,847,433,862 46

(Member Federal Deposit Insurance Corporation.)

1. What are the important differences between the operating statement and balance sheet of a bank and of an industrial com-

pany? Compare the "net worth to debt" ratio of the Guaranty Trust Company with that of The Yale & Towne Manufacturing Company.

2. Name and describe the most significant items on this bank's balance sheet.

3. What is the difference between a bank's surplus and the surplus of an industrial concern?

4. What led to the passage of the act requiring a guarantee of bank deposits?

5. EUREKA, INC.

PROPOSED CAPITAL STRUCTURE OF A NEW COMPANY

In 1935, Dr. Henry Dietz, a professor of chemistry in one of the large Middle Western universities, and three friends decided to form a small company to manufacture a chemical product developed by Dr. Dietz. The first important problems which arose were those of securing sufficient capital for the company, of determining its capital structure, and of dividing the ownership.

Dr. Dietz, after years of study, partially developed a chemical product for washing and cleaning steel to prepare it for painting. His friends felt that the possibilities of his new product were so great that they urged him to devote his full time to research to perfect it for quantity production. This he refused to do, but he made special arrangements with the university where he was teaching so that he could devote more than half his time to this work. In two years he perfected his product and produced it in quantities large enough to insure its commercial success.

During the period of experimentation and development the three men had contributed \$15,000 (\$5,000 each) to Dr. Dietz and also had persuaded several steel and automobile companies to try the product. The results secured with it were so satisfactory and a ready market with an excellent margin of profit seemed so assured that the group of men wanted to form a small chemical company immediately to exploit this product.

To buy a small factory on a railroad in the suburbs of the city where Dr. Dietz lived, and to have funds to equip and start the plant, as well as working capital, would require \$200,000. The men could not personally contribute this entire amount. They did not want to go to investment bankers or chemical companies because they were afraid their group would lose control of the proposed business. Dr. Dietz urged them to sell to their friends 1,000 shares of \$100-par-value 8% preferred stock, noncumulative for 3 years and nonvoting, and to furnish the balance of the capital themselves. Dr. Dietz had no money personally except his salary and what he received from a limited amount of consult-

ing work which he had practically discontinued in order to spend all his spare time on the new product. His annual income had never exceeded \$11,500 and for the 3 years, 1932 through 1934, his annual earnings had not exceeded \$5,000. Although he could not contribute any cash to the new company, he wanted 55% of the common stock, and proposed that his colleagues take the remaining 45% for the \$15,000 which they had advanced to him and for the \$100,000 which they would invest in the new company.

The three men hesitated to launch the new organization according to the plans suggested by Dr. Dietz. They questioned the wisdom of selling the preferred stock to their friends because they felt that their friends would be assuming too much risk for their chance of gain and would be buying on the basis of friendship rather than business. They also believed that although the venture seemed certain of success, too large a portion of their own funds would be tied up, and that giving Dr. Dietz 55% of the stock would place him in control of the company and all the funds they might put into it.

1. What should the capital structure of the company have been?

2. How should the capital stock have been divided among those interested in this project?

6. SACO-LOWELL SHOPS

SIGNIFICANCE OF CAPITAL STRUCTURE

In 1934 the attention of the Saco-Lowell stockholders was directed to the company's capital structure by the following statement in the 1933 annual report:

> It is apparent from the balance sheet that the company's capital structure is complicated, comprising as it does five classes of notes and three classes of stock; and stockholders should give consideration therefore to the position of each security in the company's capital structure and its relation to other issues with respect to priority, accumulated interest, dividends, and surplus deficit.

Until the beginning of the textile depression in 1923, the company operated successfully, paying on its common stock cash dividends, which ranged from 6% to 12% in the years 1917 through 1923. In February, 1922, the company paid a dividend of 50% in common stock on its common stock; and in November of the same year it paid a dividend of 50% in second preferred stock on all shares of common stock then outstanding. These dividends were paid at a time when the company's directors felt that the surplus was large. Regular dividends were paid on the preferred stocks up to 1925.

From 1919 to 1923 the company carried on a program of plant expansion which it financed by a sale of common stock, by bank loans, and by the reinvestment of earnings. In 1919 stockholders subscribed to 11,750 shares of new common stock at $150 a share. The par value of this stock was only $100, but at that time the company was paying dividends of 12% on its common stock. In 1923 bank loans suddenly rose to over $4,000,000 after practically all loans had been paid off in 1922. A substantial part of the new money was used for plant expansion.

During the World War and for several years thereafter, the manufacture and sale of textile machinery greatly increased to meet the requirements of foreign markets. With the loss of these markets when Japan, England, and Germany increased their pro-

duction of both textile machinery and textiles, the industry found itself with a capacity to produce both machinery and textiles far in excess of demand. These conditions reacted unfavorably on the Saco-Lowell Shops; the demand for machinery practically ceased when the textile depression deepened and when machinery from bankrupt textile companies began to compete with new machinery.

EXHIBIT 1
SACO-LOWELL SHOPS
Net Income

	Profit	Loss
1926	. .	$439,000
1927	. .	61,000*
1928	. . . .	892,861
1929	$1,004,034	. . . . .
1930	. . .	890,340
1931	. . . . .	485,951
1932	. . . .	761,002
1933	227,807	. . . .
1934	519,178	. . . .

* Not including heavy extraordinary charges for depreciation and inventory adjustment of $826,000.
Source: Company reports.

In 1927, to cope with these adverse conditions, the creditor banks installed a new management. Under the new leadership a thorough readjustment of the company's affairs was effected. Certain plants were abandoned; inventories were written down; and bank debt was replaced by notes with maturities of 3 to 5 years. Despite substantial losses from 1926 to 1932, as shown in Exhibit 1, the funded debt of the company was reduced from over $6,000,000 in 1927 to less than $3,000,000 at the end of 1934, without impairing seriously the company's current position. The various classes of notes were held for the most part by persons close to the management.

The provisions of the company's various stock issues and fixed obligations are given in Exhibit 2. Balance sheets indicating the capital structure of the company on selected dates are shown as Exhibit 3.

1. What methods were used by the company to finance its expansion from 1919 to 1923?

2. Would the company's capital structure have been sounder if mortgage bonds instead of bank loans had been used during the expansion period?

3. What financial problems did the company face because of its capital structure?

4. What relationship, if any, should exist between the earning capacity and the capital structure of this company?

5. What would be the ideal capital structure for this company?

EXHIBIT 2
SACO-LOWELL SHOPS
Provisions Relating to Securities[1]

FUNDED DEBT (AS OF DECEMBER 31, 1934)

1. *3-Year 5% Class A Notes.*

Have priority as to principal and interest over convertible class C and convertible class D notes, and also over class B notes. A sinking fund operates each year in amount up to 50% of net income in previous year to retire an equivalent amount of notes 60 days after end of each year. No lien of any kind may be placed on any of the company's assets. Class A notes must be paid in full before any dividends are paid on capital stock. Class A notes are in default if not covered by net quick assets (excess of cash, receivables and inventories over current liabilities). No further amounts may be issued except for refunding purposes.

2. *7% Class C Convertible Gold Notes.*

Have priority as to interest after interest on class A notes and as to principal after both interest and principal on class A notes. Consolidation permitted on 60 days' notice to convertible noteholders unless 50% of convertible noteholders object. Convertible into common shares on basis of 10 common shares for each $100 of notes.

3. *Class D Convertible Gold Notes.*

Interest at the rate of 7% per annum is deferred to maturity and subordinated to full payment of principal and interest on class A notes. Receives interest of 5% on accruals of deferred interest. In all other respects these notes have same provisions as class C convertible notes.

4. *Class B Notes.*

Class B notes are subordinated: (*a*) as to the payment of principal and as to the payment of interest at the rate of 7% per annum (with interest thereon), to the payment of principal and interest on the class A notes, and (*b*) as to the payment of principal and as to the payment of 2% interest in excess of 5% per annum (with interest thereon), to the payment of principal and interest on the class C and class D convertible notes.

NOTE: Payment of the principal of the 10-year 6% loan is subordinated, in certain events, to the payment of principal of and interest on the 5% class A notes.

CAPITAL STOCK (AS OF DECEMBER 31, 1934)

1. *6% Cumulative Preferred Stock.*

Authorized and outstanding, $1,250,000; par $100. Has preference as to assets and dividends. In liquidation entitled to 115. Callable as a whole on any dividend date on 60 days' notice at 115. After payment of preferred dividends and 6% on common, 35% of earnings are to be reserved and not paid out on common unless net quick assets are double preferred outstanding. (Company's by-laws allow securities of other companies to be included in net quick assets at fair market value). No mortgage can be created without consent of 75% of preferred. No additional preferred can be issued, except for cash at par and only when (except with consent of two-

[1] Condensed from Moody's *Industrials*

EXHIBIT 2 (*Continued*)

thirds of preferred) net earnings for each two preceding fiscal years have been at least twice the annual dividend requirements of preferred outstanding and to be issued. Except as specified above, 6% first preferred and common have equal voting power. Regular dividends paid quarterly, Jan. 1, etc., to July 1, 1925; none thereafter.

2. *7% Cumulative Second Preferred Stock.*

Authorized and outstanding, $2,643,800; par $100. Issued in 1922 as a stock dividend. Has second preference as to assets and dividends. In liquidation entitled to 105. Callable by a majority vote of common stockholders, as a whole on any dividend date on 30 days' notice at 105. Has no voting power. After all dividends on both classes of preferred shall have been provided for, any remaining net profit or surplus may be used to purchase this issue at not exceeding 105 at discretion of directors. Regular dividends paid quarterly, March 1, etc., to March 1 1925; none thereafter.

3. *Common Stock.*

Authorized, 132,138 shares; outstanding, 68,482 shares; held for conversion, 47,769 shares; no-par (changed from $100-par and authorized amount increased from 52,875 shares March 9, 1925). Has equal voting power with first preferred (No. 1) subject to certain restrictions exercised by latter Dividends paid on old common ($100-par) as follows: 1916, 1½%; 1917, 9%; 1918 to 1921, incl., 12% per annum; 1922, 8%; 1923, 6%; 1924 and 1925, none. Paid stock dividend of 50% in common Feb., 1922, and 50% in second preferred, Dec., 1922. No dividends paid on no-par shares.

EXHIBIT 3

SACO-LOWELL SHOPS

Consolidated Balance Sheet, as of December 31

	1912	1921	1922	1925
ASSETS				
Cash	$ 141,595	$ 2,081,677	$ 525,711	$ 657,747
Notes and Accounts Receivable	1,840,195	3,319,719	3,883,951	2,860,967
Merchandise	1,249,904	1,782,092	1,598,540	3,073,411
Securities	483,200	1,200,498	461,751	1,043,417
Government	...	104,213	...	...
Prepaid Items	57,950	116,632	91,365	176,750
Real Estate, Machinery, Equipment	2,533,320	6,013,300	5,819,501	7,376,537
Total Assets	$6,306,164	$14,618,131	$12,380,819	$15,188,829
LIABILITIES				
Accounts Payable	$ 144,560	$ 230,323	$ 317,753	$ 281,334
Accrued Interest and Pay Roll	...	...	...	90,117
Reserve for Taxes	...	563,937	...	507,402
Notes Payable	1,744,911	2,940,000	285,000	4,000,000
General Reserve	...	...	505,384	...
Five-Year 7% Convertible Gold Notes, Due Apr. 15, 1930	...	...	...	1,567,400
6% Preferred Stock	1,250,000	1,250,000	1,250,000	1,250,000
7% Second Preferred Stock	...	...	2,643,800	2,643,800
Common Stock	2,350,000	3,525,000	5,287,500	4,848,776
Surplus	816,693	6,108,871	2,091,382	...
Total Liabilities	$6,306,164	$14,618,131	$12,380,819	$15,188,829

NOTE: At a meeting of stockholders held Mar. 9, 1925, the 52,875 shares of common stock then outstanding were changed from par value of $100 per share to no-par value. The stockholders also authorized 79,313 additional shares of no-par value common stock to be reserved for the conversion of $2,643,750 five-year 7% convertible gold notes on the basis of 3 shares of common stock for each $100 face value of notes.

EXHIBIT 3 (*Continued*)

	1927	1929	1932	1934
ASSETS				
Cash (or equivalent)	$ 1,918,625	$ 1,375,123	$ 532,361	$ 937,207
Notes and Accounts Receivable	2,211,701	2,313,669	837,842	1,247,809
Inventories	1,731,110	2,092,736	695,381	1,176,780
Securities at Estimated Realizable Value	691,223	353,445	164,361	131,279
Deposits with Mutual Insurance Companies	......	57,880	47,833	45,224
Accrued Interest Receivable	......	7,900	.....	16,091
Total Current Assets	$ 6,552,659	$ 6,200,753	$2,277,778	$3,554,390
Real Estate, Machinery, and Equipment	6,612,607	4,940,310	4,533,726	4,242,954
Deferred Charges	143,292	39,505	28,371	18,633
Total Assets	$13,308,558	$11,180,568	$6,839,875	$7,815,977
LIABILITIES				
Accounts Payable and Accruals	$ 746,877	$ 359,143	$ 132,968	$ 515,771
Reserves for Federal Income, Federal Capital Stock and State Taxes	...	....	......	116,540
Five-year 7 % Convertible Notes, Due Apr. 15, 1930	....	122,400	......	....
Ten-year Loan Payable, Amount Due Jan 1, 1933	....	..	37,500	....
Total Current Liabilities	$ 746,877	$ 481,543	$ 170,468	$ 632,311
5 % Class A Notes, Due Jan. 14, 1936	4,550,000	3,412,500	1,274,000	900,507
7 % Class C Convertible Notes, Due Jan. 15, 1936	500,170	478,120	477,690	62,300
7 % Class D Convertible Notes, Due Jan. 15, 1936	....	......	....	415,390
5 % Class B Notes, Due Jan. 15, 1936	895,000	895,000	895,000	895,000
7 % Convertible Notes, Due 1930	122,400	......	......	......
Accrued Interest on Class B and D Notes, Due Jan. 15, 1936	.....	......	106,654	305,510
Total Funded Debt	$ 6,067,570	$ 4,785,620	$2,753,344	$2,578,707
Ten-year 6 % Loan Payable, Due 1934 to 1942	....	....	312,500	262,500
Reserve for Sundry Contingencies	.....	263,142	53,881	43,418
6 % Cumulative Preferred Stock*	1,250,000	1,250,000	1,250,000	1,250,000
7 % Cumulative Second Preferred Stock†	2,643,800	2,643,800	2,643,800	2,643,800
Common Stock and Surplus	2,600,311	1,756,463	344,118[d]	405,241
Total Liabilities	$13,308,558	$11,180,568	$6,839,875	$7,815,977

* Dividends accumulated, Dec. 31, 1934, $712,500.
† Dividends accumulated, Dec. 31, 1934, $1,804,394.
[d] Deficit.
Compiled from company reports.

SUMMARY QUESTIONS

1. Which financial instruments indicate ownership and which debt? What are the relative positions of the claims of these two classes? What are the responsibilities and obligations of each class?

2. What are the essentials in sound capital structure? Do these vary among industrials, utilities, railroads, banks?

3. Discuss the advantages and disadvantages of the following instruments in a financial structure: first mortgage bonds; debenture bonds; convertible bonds; preferred stocks; par and no-par common stocks.

4. What are the reasons frequently leading to involved capital structures?

5. Discuss the fundamental differences between the balance sheet of an industrial company and that of a commercial bank.

6. Should bonds be considered "permanent capital"?

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III

PROCURING FUNDS FOR A CORPORATION

One of the most perplexing problems confronting the business executive is how to secure funds most advantageously for the operation of the business. The methods of securing funds fall into four general groups: (1) selling stock representing ownership; (2) borrowing through the issuance of bonds and other credit obligations; (3) impounding of earnings; and (4) making use of the credit extended by those from whom the company makes its purchases.

The general problem of securing funds may be divided into two parts: (1) securing funds to start a company or to launch a new project; and (2) obtaining additional funds for a going concern. The problems involved in securing capital for a new concern are likely to differ greatly from those which arise in connection with raising funds for a going concern.

When those launching a new venture ask for capital, their request is usually based merely upon ideas, hope, enthusiasm, and estimates of probable costs and earnings. They must convince those possessing funds that, although the risks of investment may be great, the probable profits are substantial enough to warrant assumption of those risks. Consequently their task is to paint a glowing picture of the future of their venture by preparing attractive prospectuses, pointing out success in the same or allied fields, and dwelling on the many alleged advantages of the new product or service. They may talk about "getting in on the ground floor," or about the profits to be made from an "infant industry." The originators of the enterprise may not be qualified to raise the necessary funds themselves, and will therefore utilize the services of a group of men called "promoters," who have imagination, sales ability and the necessary contacts. Such services are frequently paid for in stock, and the promoters are often of great assistance in establishing the company. The promoters may attempt to secure all the required funds from one

source, or they may attempt to secure small amounts from many sources. Although persons with small savings often are more credulous and part with their savings more readily than those with larger amounts of funds available for investment, promoters generally prefer to secure capital in one or several large blocks, because this method is usually cheaper and quicker.

Men experienced in furnishing capital for new ventures recognize the dangers involved, and not only demand the opportunity for substantial profit in case of success but also insist on a voice in the management even during the earlier developmental stages of the project. They base their decision as to the wisdom of advancing funds on the following: (1) a thorough study of the venture, including competition, the market, probable costs, and probable profits; (2) a careful examination of patents, if any; (3) an investigation of the character of the men launching the venture; (4) their own estimates of the probable total capital needs with which to check the amounts requested; and (5) their own probable influence and position in the management of the company as it develops. When a new venture is launched with the support of a large and well-established company, however, the problem of finding capital is greatly simplified: the parent company itself ordinarily has either the necessary resources or credit facilities which will supply them.

Obtaining funds for a going concern presents radically different problems from those faced by an unknown company. Banks, private capitalists, insurance companies, and other investment organizations may supply funds for a well-established organization. Investment banking houses and commercial banks are the usual sources of funds for a going concern. Commercial bankers ordinarily make short-term loans for working capital purposes and investment in corporation bonds, and investment bankers make and carry out plans to secure funds for fixed capital purposes. It is exceedingly important, therefore, that any company likely to need additional fixed or working capital funds maintain the confidence of its bankers.

The relationship of a company with its investment bankers is entirely different from the day-to-day contact with its commercial bankers. Often a company may not need the services of investment bankers for a period of years. Sometimes, however, a company makes a practice of having an investment banker on its

board of directors in order to facilitate new financing when the need arises.

The methods of raising capital and the costs and liabilities incurred vary with general business conditions, with conditions in the security market, with the condition of the company itself, and with the financial fashion of the period. In many cases companies have succeeded in obtaining funds, but only at a cost so great as to contribute materially to later difficulties. Doubtless many of these companies would have been better off if they had been unable to raise the funds for what was at the time considered a worth-while purpose.

The determination of a sound method of raising funds is important, both because of the responsibilities assumed by the company and because of the effect of the method used on the reputation of the company among bankers and with the public. The problems involved in attempting to procure funds are many and varied, ranging from technical questions of pricing the securities to general considerations, such as whether or not to sell the securities to the company's customers.

Section III contains problems concerning sources of funds. The technical problems involved in securing capital, however, will be covered in more detail in later sections of the book.

1. HARTLEY CANDY COMPANY

PROPOSED PLAN FOR A NEW CORPORATION

Early in 1934 Miss Evelyn Hartley proposed to establish in California a new corporation to be known as the Hartley Candy Company. She had established and was successfully operating a candy business in St. Louis, known as Evelyn Hartley, Inc. Because she believed that a real demand existed for candy containing a minimum of fattening ingredients, Miss Hartley had been developing a series of new recipes. California fruit juices would be an important element of these candies.

The proposed financial structure of the company which would produce these candies was to be as follows:

1,500 shares of $100-par preferred stock, and
1,000 shares of $100-par common stock.

The preferred stock was to be sold at par for cash, and Miss Hartley agreed to underwrite $25,000 worth of preferred stock. This issue was to have preference as to dividends to the extent of 8% (noncumulative) and was to participate on equal terms with the common stock after common stock dividends of 8% had been paid in any one year. The preferred stock would have equal voting rights with the common and would be preferred as to assets in liquidation.

The 1,000 shares of $100-par common stock were to be issued to Miss Hartley in exchange for the recipes, trade-marks, and copyrights. She agreed, however, to donate $50,000 of the common stock to the company so that it could be issued at some later date to provide additional working capital. In addition Miss Hartley was to be paid a royalty of three cents a pound on all candy sold in consideration of the small amount of capital stock to be issued to her. The payment of royalties, however, was to be contingent on the following conditions:

1. No royalties whatever were to be paid in any year in which net profits (excluding royalties) for that year were not equal to 8% of all the outstanding capital stock.

2. Royalties in any one year were to be noncumulative and were to be paid out of profits after the payment of 8% on the capital stock.

Of the $150,000 to be received from the sale of the preferred stock $3,000 was allowed to cover the cost of obtaining the necessary funds. A factory of sufficient size to produce enough candy to meet the expected sales for the first three years could be fully equipped in a leased building for $45,000. The remaining $102,000 would cover, it was estimated, all the costs of producing 120,000 pounds of candy or one-fifth of the expected yearly production.

An annual production of 600,000 pounds was judged a conservative estimate of what could be manufactured and sold after a short period of sales promotion. Sales were to be made through candy brokers aided by an advertising campaign. An annual net profit of about 30% of the total capital stock could be reasonably expected according to the following figures:

Expense	Amount	Cents per pound
Ingredients	$102,000	17.00
Boxes and Packing	150,000	25.00
Factory Labor	28,200	4.70
Packing and Shipping	5,000	0.83
Office	10,000	1.67
Salesmen's Salaries and Brokerage	30,000	5.00
Traveling Expenses	36,000	6 00
Advertising	60,000	10 00
Prepaid Transportation	50,000	8 33
Royalties	30,000	5 00
Rent	4,500	0 75
Stationery and Postage	2,000	0 33
Depreciation	5,000	0 83
Returns and Allowances	5,000	0 83
Bad Accounts	5,000	0 83
Taxes and Sundries	2,500	0 42
Estimated Expenses	$525,200	87.5+
Estimated Profits	74,800	12 5−
Estimated Sales	$600,000	100.0

1. Was the financial plan sufficiently attractive to interest new capital?

2. Was preferred stock a desirable security for this company to issue?

3. What were the weaknesses of the proposed plan?

4. How should the preferred stock have been sold to the public?

2. BARRY CORPORATION

SECURING ADDITIONAL FUNDS FOR A PROMOTION

In January, 1932, the syndicate managers who had been asked a third time to supply additional funds for the Barry Corporation, examined critically the outlook for the company. The purpose of their inquiry was to revise their policies as syndicate managers or to recommend the discontinuance of all efforts to promote the company.

In March, 1931, a syndicate agreement was made between three men as syndicate managers and two men and a corporation as subscribers, to buy not less than a majority of the common stock of a company to be known as the Barry Corporation, to provide the company with additional working capital, and to "control the destiny of the Barry System owned by the company and said to be fully covered by Letters Patent of the United States."

The syndicate managers were Mr. Thomas Armstrong and Mr. Thomas Holbrook of Boston and Mr. J. T. Turner of New York City; the subscribers were Mr. Herman Armstrong of Orange, New Jersey, Mr. Alfred Armstrong of Boston, and the General Promotion Corporation. Mr. Herman Armstrong was the president and general manager of the Barry Corporation at an annual salary of $8,000. He was a consulting engineer who had acted for over 30 years as a promoter for numerous technical devices. It was through him that the other subscribers had become interested in the corporation. His brother, Mr. Alfred Armstrong, was a widely known business man experienced in reorganization work. In addition to serving as an officer of a large commercial bank, he had been appointed receiver for bankrupt concerns on five or six occasions. Since 1920, however, he had retired from banking and his direct contact with business had been as a consultant. Mr. Thomas Armstrong was Mr. Alfred Armstrong's son. Both he and Mr. Holbrook were in business in Boston so that it was impossible for either of them to give his

whole time to the Barry Corporation. Mr. Barry, who had developed the Barry System, was the vice president and consulting engineer of the company and might be described as a typical inventor. He was absolutely convinced of the merit of his product, and felt that research and constant study of the product for improvement were of little significance in the introduction of the Barry System commercially. Mr. Barry owned 350 shares of common stock and in addition had a five-year contract with the company which fixed his annual salary at $8,000.

The subscribers by the agreement appointed the syndicate managers their irrevocable agents and attorneys, with full power and authority to do any and all acts deemed by the managers necessary, proper, or expedient in carrying out the purposes of the syndicate. The managers were to have sole discretion and management of the syndicate but were not to be liable for any matter connected therewith except for want of good faith and failure to exercise reasonable diligence. Participation in assessments or distribution of assets was to be on the following basis: General Promotion Company, 50%; Alfred Armstrong, 33⅓%; and Herman Armstrong, 16⅔%.

The syndicate originally subscribed the following amounts:

General Promotion Company	$15,000
Alfred Armstrong	10,000
Herman Armstrong	5,000
	$30,000

Each subscriber paid in the beginning 50% of this subscription. In addition the syndicate subscribed tentatively to 750 shares of preferred stock at $100 and 550 shares of common at $1 per share. The subscribers were to pay their respective subscriptions at one time or from time to time at the call of the managers but were not equally liable for payment of any sum of money or any assessment in excess of their original subscription unless they were willing to make an additional investment in Barry Corporation. In case a member of the syndicate refused to contribute when others did, his share in any ultimate distribution was merely lowered.

The syndicate was to be in force for 5 years but could be terminated at any time by the discretion of the managers. Upon the termination of the syndicate and after the discharge of all its liabilities and the completed performance of all its agreements, the

managers were either to convert the syndicate assets into cash and distribute it among the subscribers in proportion to the amounts they had paid in their subscriptions or to distribute the assets in the same proportion in the form in which they might exist at the termination of the syndicate.

The Barry Corporation, engaged in manufacturing, selling, and installing equipment for preventing slime, scale, and corrosion in boilers, heaters, condensers, and other apparatus, had been incorporated under the laws of the State of New York in May, 1929. Mr. Thomas Barry, a Scotchman, was the inventor of the Barry System. His youth had been spent on the sea and he had become interested in the corrosion and scale problems confronting naval engineers. The Barry System had been inspired by an electrolytic installation which Mr. Barry had observed on an English boat. The installation was unsuccessful, but Mr. Barry studied it with a view to discovering the difficulty. His knowledge of electrolysis was limited to what he had gained through first-hand experience. By 1925 he believed that he had found the fundamental fault and he proceeded to perfect the new system based on his findings.

The following explanation was made of the Barry System at the time the syndicate was formed.

Since the invention of the steam engine the two great enemies of efficient steam power production have been scale and corrosion. These two evils are responsible for inefficiency due to poor heat transfer, failure of tubes through bagging as well as the deterioration through corrosion of the metal of all steam plant equipment.

Various schemes—chemical, mechanical and electrical—to prevent the inroads of corrosion and scale on the life and efficiency of such equipment have been advanced from time to time. Frequently the remedies have been worthless or mere temporary palliatives; others, while decreasing one of the evils, would increase the other. Scale and slime can be removed at great expense from boilers and condensers by mechanically cleaning them or by chemical treatment but this does not prevent and usually increases the ever-present danger from corrosion.

The idea of preventing corrosion and scale formation electrolytically is old and has been attempted numerous times but its application to practical use was only partially successful until the advent of the system covered by the Barry patents. Vital points overlooked by previous investigators were covered therein.

The market for the equipment was nation-wide and in those sections with bad boiler water the need for protection of boilers

was very great. It was estimated that for most companies the annual savings in fuel costs alone would equal the total cost of the apparatus. Because of this great saving the officers of the company felt strongly that the equipment should be leased rather than sold outright. Competition existed chiefly with chemicals but experts did not agree on the benefits of these products.

EXHIBIT 1
BARRY CORPORATION
Profit and Loss Statement—Year Ended December 31, 1931

Income:		
Gross Sales (11 installations)	$22,099 02	
Less Cost of Sales	31,560.72	
Loss on Sales		$ 9,461 70
Other Income:		
Option Agreement		1,800 00
Total Income (Loss)		$ 7,661 70
Expenses:		
General Expenses	$30,943.85	
Special Charges	1,800 00	$32,743 85
Loss, 12 months, 1931		$40,405 55

Enough equipment had been sold to indicate that the apparatus would function properly. On almost every installation, however, service was necessary because of the special water conditions encountered. Of the numerous units sold, all with a full guarantee, only one was not accepted. The return of that unit was caused as much by lack of service and by the personalities involved as by failure of the apparatus. At the end of 1931 when the syndicate managers reviewed the progress of the Barry Corporation the operating results were as shown in Exhibit 1, and the balance sheet items as shown in Exhibit 2.

One of the chief difficulties encountered by the syndicate managers during the period over which they had control of the Barry Corporation had been differences of opinion between Mr. Herman Armstrong and Mr. Barry. Mr. Barry constantly urged that additional funds be advanced to the company to finance more aggressive sales policies which in his opinion would quickly result in the rapid success of the company. He felt that Mr. Herman Armstrong was influenced by the opinions of the syndicate group providing the funds, and consequently was more hesitant toward any plans for the rapid development of the com-

pany than he should have been. Mr. Armstrong's position was difficult; he tried to steer a middle course between pushing sales aggressively without regard to expense and using funds carefully to secure the maximum results so that the syndicate group would not lose confidence in his policies. By arrangements with Mr. Barry and Mr. Armstrong the syndicate had reduced drastically the salaries of both men for one year although they had salary contracts. Both were displeased, however; Mr. Barry in particular urged the payment of his contract salary. Mr. Barry requested furthermore that the syndicate managers advance $50,000 at once so that the company's plans could be carried out.

EXHIBIT 2
BARRY CORPORATION
Balance Sheet, as of December 31, 1931

ASSETS	
Cash	$ 4,508
Accounts Receivable	4,126
Syndicate Subscriptions Receivable	2,812
Inventory	8,604
Machinery and Tools, Less Reserve	1,810
Furniture and Fixtures, Less Reserve	809
Special Deposits	40
Unexpired Insurance	73
Patents and Goodwill	58,453
Total Assets	$ 81,235
LIABILITIES	
Accounts Payable	$ 1,769
Preferred Capital Stock*	127,000
Common Capital Stock†	1,000
Deficit	48,534
Total Liabilities	$ 81,235

* Preferred stock was owned by syndicate members as well as several outside groups.
† Distribution of common stock

The Syndicate	550 shares
Mr. Thomas Barry	350 shares
Mr. Herman Armstrong	100 shares
	1,000 shares

1. What were the duties of the syndicate managers?
2. Should they have requested the syndicate to advance $50,000 to carry out Mr. Barry's plans?
3. What were the main problems faced by the syndicate managers?
4. Were the risks incurred in putting new capital into this venture adequately covered by the prospects for profit?

3. RADIO CORPORATION OF AMERICA

SECURING CAPITAL FOR A NEW INDUSTRY

The financial history of the Radio Corporation of America, and certain of the problems of a financial nature which arose during its development are described in Section VIII, pages 282 to 294. This case should be studied in detail, with emphasis on (1) the methods used for securing capital for this new industry; and (2) the problems raised by the company's capital structure.

1. What were the sources of capital used by the company from its beginning up to 1934?
2. Did the company secure its capital in a wise manner?
3. What part of the company's capital structure led to the company's difficulties during the depression?
4. What was the significance of the close tie-in between this company and the General Electric Company and the Westinghouse Electric and Manufacturing Company?

4. WARREN BROTHERS COMPANY

RAISING CAPITAL BY BONDS AND PREFERRED AND COMMON STOCKS; CHANGES IN CAPITAL STRUCTURE

Warren Brothers Company was incorporated under the laws of West Virginia in 1900 and was the continuation of a paving business which the organizer had conducted since 1882. After incorporation the company grew rapidly;[1] its output increased from 1,000,000 square yards of paving laid annually in the early years of the company's history to about 10,000,000 square yards annually from 1922 to 1929. This rapid growth created at frequent intervals a large demand for new funds which the officers of the company were compelled to secure irrespective of the market conditions for funds at the time when the need arose.

From its origin the company's products had been protected by basic patents and, as a rule, new processes were patented as they were developed by the research department. In addition to its road-building business the Warren Brothers Company licensed other companies to construct its patented pavements; it also manufactured and sold paving machinery. Warren Brothers Company, through its subsidiaries, operated in many foreign countries as well as in the United States.

While the working capital for temporary and seasonal requirements was commonly raised by its subsidiaries, the parent company financed nearly all permanent capital requirements necessitated during this 30-year period of expansion. Because of the nature of the company's business and its rapid growth, it was forced to borrow heavily from banks much of the time. These loans were converted several times into bond issues. The size of the bank loans from time to time can readily be seen by examining Exhibit 1. The increases in the company's funded debt and its capital stock, and the type of securities issued are indicated in Exhibits 1, 2, and 3.

[1] Balance sheets for significant years are shown in Exhibit 1. Gross income and earnings are shown in Exhibit 4.

EXHIBIT I
WARREN BROTHERS COMPANY
Condensed Consolidated Balance Sheet, as of December 31
(In thousands of dollars)

	1906	1917	1920	1922	1925	1928	1930	1931	1932	1934
ASSETS										
Cash	$ 43	$ 488	$ 928	$ 543	$ 612	$ 1,542	$ 2,309	$ 1,066	$ 783	$ 441
Accounts and Notes Receivable	785	1,838	4,145	2,637	1,023	4,043	1,879	1,035	392	900
Inventories	246	747	1,081	200	240	814	521	207	153	140
Other Current Assets	64	141	121	387	693	3,474	871	353	...	...
Total Current Assets	$1,138	$3,214	$ 6,275	$ 3,767	$2,568	$ 9,873	$ 5,580	$ 2,661	$ 1,328	$ 1,481
Government Obligations, Tax Liens, etc	...	...	...	...	...	1,375	14,234	16,190	14,868	15,654
Investments	914	2,383	2,938	4,665	4,894	3,695	6,098	4,976	4,390	4,009
Fixed Assets	329	802	1,019	628	888	3,432	1,789	1,822	1,556	1,533
Other Assets	2,139	2,089	1,672	1,800	153	2,995	1,271	1,420	344	311
Total Assets	$4,520	$8,488	$11,904	$10,860	$8,503	$21,370	$28,972	$27,069	$22,486	$22,988
LIABILITIES										
Notes Payable	$ 637	$1,076	$ 4,000	$ 461	...	...	$ 3,623	$ 285	...	$ 257
Accounts Payable and Accruals	...	261	473	674	$ 596	$ 4,469	2,820	705	$ 238	511
Total Current Liabilities	$ 637	$1,337	$ 4,473	$ 1,135	$ 596	$ 4,469	$ 6,443	$ 990	$ 238	$ 768
Funded Debt:										
6 % Collateral Bonds, Due 1919–1927	...	1,005	704	480	...	...	...	...	...	...
5 % Debentures, Due 1922	25	...	...	...	...	...	...	...	...	
7½ % Debentures, Due 1937	...	...	...	1,921	40	...	...	...	...	...
5½ % Gold Notes, Due 1937	...	...	...	...	...	2,500	2,250	2,050	1,763	1,488
7½ % Serial Debentures (pesos)	...	...	...	...	...	1,206	838	1,725	1,179	1,087
6 % Convertible Debentures, Due 1941	...	...	...	...	...	...	...	5,000	4,721	4,457
Total Funded Debt	$ 25	$1,005	$ 704	$ 2,401	$ 40	$ 3,706	$ 3,088	$ 8,775	$ 7,663	$ 7,032
Loan Payable of Subsidiary, Due 1936	...	...	...	...	...		...		...	481
Reserves	145	405	302	800	151	1,080	2,373	2,598	1,725	3,721
Other Liabilities	26		...	...	45	...	2,572	...	...	139
Capital Stock:										
First Preferred	1,304	2,000	2,000	1,935	1,991	1,987	454*	329	329	288
Second Preferred	100	500	500	499	441	497	122*	121	121	79
Common	2,000	2,000	2,005	2,260	4,142	7,448	7,565	7,565	7,565	7,565
Convertible Preferred	...	...	...	...	...	...	1,821	1,947	1,931	2,031
Minority Interest	...	...	...	...	...		...		...	31
Surplus	283	1,241	1,920	1,830	1,097	2,183	4,534	4,744	2,914	853
Total Liabilities	$4,520	$8,488	$11,904	$10,860	$8,503	$21,370	$28,972	$27,069	$22,486	$22,988
Contingent Liabilities	...		...	$ 1,331	$1,278	$ 1,745	$ 1,378	$ 1,130	$ 946	$ 640

* New preferred stock for 1930 and thereafter.
Compiled from company reports.

EXHIBIT 2
WARREN BROTHERS COMPANY
Funded Debt Issued or Outstanding on Selected Dates

Date	Description of new bonds and notes	Amount authorized and issued	Total funded debt outstanding as of December 31
1901	....	.....	none
1902	Debenture bonds.	*	$ 174,000
1903	Debenture bonds	*	266,000
1904	Debenture bonds, 5%, due 1922	*	406,000
1905	Debenture bonds, 5%, due 1922	*	33,000
1909	Collateral trust sinking fund notes, 6%, due 1919	$ 500,000	530,521
1917	First collateral trust gold bonds, 6%, due serially 1918 to 1927	1,000,000	1,005,000
1922	Convertible sinking fund gold debentures, 7½%, due 1937	2,000,000†	2,401,000
1926	....	......	none
1927	Sinking fund gold notes, 5½%, due 1937	2,500,000	2,500,000
	Serial debentures, 7%, payable in pesos	*	1,550,206
1931	Convertible sinking fund gold debentures, 6%, due 1941....	5,000,000	8,774,661
1934	....	.....	5,944,500

* Data not available.
† Authorized $3,000,000, balance reserved for corporate purposes.
Compiled from company reports and Moody's *Industrials*.

FUNDED INDEBTEDNESS[1]

The company brought out its first large bond issue in 1917 when a $1,000,000 issue of first mortgage and collateral trust 6% serial gold bonds was sold. These bonds were issued to supply additional capital and to help meet current liabilities.

The company entered the 1920 depression with accounts and notes payable on September 30, 1920, of $5,795,000. This large amount of current liabilities was reduced by payment from the company's cash funds and from the proceeds of a $2,000,000 issue of 7½% 15-year convertible sinking fund collateral debenture bonds dated January 2, 1922. At the same time the company still had outstanding $500,000 of its first mortgage and collateral trust bonds, part of the $1,000,000 issue sold in 1917. Both these series of bonds were retired by 1926.

[1] See Exhibit 2.

EXHIBIT 3
WARREN BROTHERS COMPANY
Summary of Provisions Relating to Capital Stock

Class of stock	Date authorized	Dividend rate	Par value	Preference	Provisions for conversion	Provisions for call	Voting power
1. First preferred*.....	Mar. 13, 1920	6 % cumulative	$50	First, as to assets and dividends	None	None	One vote per share, equally with other classes
2. Second preferred† ...	Mar. 13, 1920	7 % cumulative	$50	Second, as to assets and dividends	None	None	One vote per share, equally with other classes
3. Common‡.........	Mar. 13, 1920	As voted by directors after 5 % reserve for bonds	no par	None	None	None	One vote per share, equally with other classes
4. First preferred........	Apr. 8, 1930	$1 cumulative	no par	First, as to assets and dividends, $16⅔ in liquidation	3 shares for 1 share of cumulative convertible preferred	None	One vote per share, equally with other classes
5. Second preferred....	Apr. 8, 1930	$1.16⅔ cumulative	no par	Second, as to assets and dividends, $16⅔ in liquidation	3 shares for 1 share of cumulative convertible preferred	None	One vote per share, equally with other classes
6. Cumulative convertible preferred	Apr. 8, 1930	$3 cumulative	no par	Third, as to assets and dividends, $50 a share in involuntary liquidation $60 a share in voluntary liquidation before Dec. 31, 1933, $50 thereafter	Share for share of common before Dec 31, 1931 1⅓ for 1 of common to Dec 31, 1932. 1⅔ for 1 of common thereafter to Dec. 31, 1933, when convertibility expires	$60 per share to Dec. 31, 1933; $55 thereafter	One vote per share, equally with other classes
7. Common stock§......	Apr. 8, 1930	...	no par	.	. . . . .	... .	One vote per share, equally with other classes

* Exchanged for issue No. 4 at rate of 3 new for 1 old share, 1930.
† Exchanged for issue No. 5 at rate of 3 new for 1 old share, 1930.
‡ Exchanged for issue No. 7 at rate of 3 new for 1 old share, 1930.
§ Other provisions· Reserved for bankers' option to purchase at $40 a share until Mar 1, 1936, 50,000 shares; in treasury, 6 shares. Reserved for conversion of debentures, 111,111 shares. Reserved for conversion of preferred, 47,945 shares.
Source of data· Company's announcements of issues; Moody's *Industrials*

Because of the rapid expansion of the company's business in 1926 and 1927 (see Exhibit 4), almost doubling gross income during these years, additional funds were again urgently needed. The need was accentuated by the company's contract to build roads in Cuba. In addition to heavy bank borrowing the company sold in 1927 a $2,500,000 issue of 10-year 5½% sinking fund gold notes. At the same time, in order to help finance its business in the Argentine, the company guaranteed an issue of over $1,775,000 of 7% serial debentures of the Warren Brothers Company of Argentina, payable in pesos.

EXHIBIT 4
WARREN BROTHERS COMPANY
Gross Income, Earnings, and Dividends, 1925–1934

Year	Gross income	Earnings	Total dividends paid (preferred* and common†)
1925	$ 4,813,000	$ 794,367	$ 565,630
1926	9,950,000	995,927	737,474
1927	16,684,000	1,483,898	730,043
1928	28,118,000	2,159,103	937,513
1929	35,364,000	3,002,238	1,094,132
1930	28,191,000	3,025,008	1,521,141
1931	9,212,000	935,515	1,090,032
1932	4,100,000	317,983‡	none
1933	2,295,000	661,208§[d]	none
1934	3,956,000	800,322[d]	none

* Dividends on all classes of preferred stocks were paid regularly from the time of issue up to January 1, 1932, with the exception of two years following the panic of 1907 and during 1921. These deferred dividends afterwards were paid in full.

† Common stock dividends were paid as follows:

1902	52 % in cash	1923	$2 25
1905	4 % in cash	1924	3 75
1911	10 % in second preferred	1925	4 00
	stock at par	1926	5 00
1912	10 % in second preferred	1927	5 00
	stock at par	1928	5.00
1913	20 % in first preferred	1929	6 00
	stock at par	1930	3 00
1916	4 % in cash	1931	2 00
1917	3 % in cash		

‡ Before Surplus charges of $2,147,372.

§ Before charge to Surplus of $1,200,000 (1934 report). Includes in earnings accrued interest of $378.937 on Cuban bonds and $137,642 on Argentine obligations.

[d] Deficit.

Compiled from company reports.

No further bond financing occurred until 1931 when a $5,000,000 issue of 6% sinking fund debentures was sold to take care of current liabilities and insure adequate working capital until the funds tied up in the Cuban contract were freed. The company's

funded debt reached a peak in 1931 of approximately $8,775,000. By July, 1935, this had been reduced to about $6,000,000, but the fixed charges on this debt still placed an exceedingly heavy burden on the company.

CAPITAL STOCK[1]

During the first 2 years of the company's existence, its total capital consisted of $75,000 about equally divided between 6% preferred stock and common stock, each with a par value of $50 a share. In 1902 all of the original stock was exchanged share for share for new second preferred stock, and a $2,000,000 issue of common stock of $50 par value was exchanged for patents owned by the president of the company. At the same time an issue of 6% first preferred stock and an additional block of 7% second preferred stock were sold for cash.

From 1903 to 1906, as the company expanded, the amount of preferred stock authorized was increased. This stock was sold for cash at par. In 1906 an additional 10,000 shares of 6% first preferred stock were authorized and were sold during the next 3 years for cash at $42.50 a share. The remaining $7.50 a share was charged on the company's books as an expense.

In 1911, an additional 10,000 shares of first preferred stock and 8,000 shares of second preferred stock were authorized. All these shares of the second preferred stock were issued in 1911 and 1912 as dividends on the common stock. Of the first preferred stock, 8,000 shares were issued as a dividend on the common stock in 1913, and the balance was sold for cash at par in the same year.

On April 17, 1917, the stockholders of the company voted to change the par value of all classes of stock from $50 to $100. In the letter of notification, it was stated that this was done "to conform with the custom of most stocks." Stockholders were asked to send in their old certificates to be exchanged for new ones on the basis of two old shares for one new one. This exchange halved the number of shares outstanding of each class, but did not affect the total par value of each class.

On August 18, 1920, the stockholders of the company voted to change the par value of the preferred stock back to $50, issuing

[1] A summary of provisions relating to capital stock is given in Exhibit 3; the dividend record, in Exhibit 4.

two new shares in exchange for one old, and to issue two new shares of no-par common stock for each old share of $100 par. At the same time, in order to provide new capital, the company offered 60,000 shares of the new common stock to its stockholders, giving each holder of any class of the new stock the right to subscribe to two-thirds of a share of the new common stock, at $35 per share. As the market price of the $100 shares had been fluctuating around $60, there was no demand for the new shares and only 143 were sold. In later years, however, additional amounts of common stock were sold for cash or issued in exchange for convertible debenture bonds.

On December 2, 1927, the board of directors voted to offer to the holders of the common and preferred stocks the right to subscribe for one share of common stock at $80 for every four shares of any issue held. This offer was fully taken up; the 41,340 shares subscribed for increased the company's capital by over $3,000,000.

In 1929 the officers and directors of the company felt that certain changes should be made in the company's capital structure in order to make it sounder and more flexible. They were of the opinion that a company with wide fluctuations in earnings should have no large bond or note issues outstanding, but that such a company should limit its capitalization to preferred, preferably convertible preferred, and common stock issues. It seemed clear that the company would constantly need a larger amount of permanent capital than it had at that time. In attempting to reach the ideal capital structure, the management constantly encountered certain confusing and difficult provisions in the two issues of preferred stock.

The following description of provisions in the stock of the corporation is taken from the listing statement of the New York Stock Exchange:

The provisions relating to stock of the corporation as contained in the certificate of reorganization dated March 13, 1920, now in effect, are as follows:

The total authorized amount of said First Preferred Stock shall be $2,000,000 divided in 40,000 shares of $50 each. The holders of said First Preferred Stock shall be entitled to receive out of the net earning a fixed yearly cumulative dividend at the rate of 6 per centum per annum . . . and no dividend shall ever be paid or set apart on the Second Preferred or Common Stock until dividends . . . at the above named

rate for that and previous fiscal years shall have been actually paid or set apart.

The total authorized amount of the Second Preferred Stock shall be \$500,000 divided into shares of \$50 each. The holders of the said Second Preferred Stock shall be entitled to receive out of surplus net earning over and above the amount required for payment of dividends on the First Preferred Stock . . . a fixed yearly cumulative dividend at the rate of 7 per centum per annum.

All classes of stock have equal voting power.

. . . . . .

Increases in the number of shares of stock authorized or changes in the par value of the stock authorized must be made by an affirmative vote of the majority of all the stock outstanding.

. . . . . .

After an increase in the capital stock of the company has been authorized the holders of the same class of stock theretofore authorized and issued have no rights in the new issue superior to the rights of the holders of other classes of stock.

. . . . . .

There is no provision for redemption of either First or Second Preferred Stock nor is either of them convertible into Common Stock.

From these provisions it was not clear whether or not rights to purchase new common stock could be offered to common stockholders without at the same time offering similar rights to both classes of preferred. Consequently, in 1928 when rights to purchase new common were offered, they were extended to all stockholders to avoid any legal difficulties over the question of "preemptive rights."

In order to remove such uncertainties the directors worked out a plan of voluntary reorganization. On March 18, 1930, the president and the chairman of the board of directors sent a letter to the stockholders (see Exhibit 5) proposing a reorganization of the capital stock. They proposed to split each class of stock into three times as many shares, and to issue a new class of stock, namely, a \$3 cumulative convertible preferred stock without par value, which would be exchanged at the rate of one share for three new shares of first preferred or one share plus \$8 cash for three new shares of second preferred. In this way it was hoped that all of the noncallable issue would be exchanged for the new callable convertible preferred. This was approved at a meeting of the stockholders on April 8, 1930. During the following years about

four-fifths of the first and second preferred stock issues was exchanged for the new issue of convertible preferred.

EXHIBIT 5
WARREN BROTHERS COMPANY
Cambridge, Massachusetts

March 18, 1930

To the Stockholders of Warren Brothers Company

The steady and substantial expansion of the business of your Company and the ever widening scope of its activities have emphasized the lack of flexibility in its capital structure. However well adapted it may have been to conditions in the earlier years of development your Board of Directors have become convinced that a rearrangement of the different classes of stock will be to the advantage of the Company and its stockholders.

Your Board of Directors therefore wishes to recommend to you the reclassification of the capital stock of the Company under a plan of voluntary reorganization pursuant to the laws of West Virginia upon the terms set forth herein. This plan was approved at a meeting of your Board after very careful consideration and it is believed by the Board to be fair and equitable to each class of stockholders.

The reorganization provides for the division of each class of stock into three times as many shares, the new shares of first and second preferred stock to be without par value, and each class of stock to have the same interest in the property and assets of the Company after the reorganization as before.

If the reorganization is authorized by the stockholders and after the same shall have been effected, it is proposed to increase the capital stock of the corporation by the authorization of 50,000 shares of new $3 convertible preferred stock without par value and to offer the same to the first and second preferred stockholders in exchange for their shares of first preferred and second preferred stock on the basis set forth below provided the number of preferred stockholders electing to make the exchange is sufficient to render the authorization and issue of the new convertible preferred stock desirable. The proposed basis of exchange is as follows:

(*a*) For each three shares of new first preferred stock outstanding there shall be issued in exchange therefor one share of new convertible preferred stock without par value.

(*b*) For each three shares of new second preferred stock outstanding there shall be issued in exchange therefor one share of new convertible preferred stock without par value plus eight dollars in cash to adjust the difference in the dividend rate.

The new convertible preferred stock without par value will be entitled to cumulative preferential dividends at the rate of $3 per share per annum; will be entitled in involuntary liquidation to $50 per share before any payments are made upon the common stock; will be callable upon not less than sixty days' prior notice on or before December 31, 1933, at $60 per share and accrued dividends and thereafter at $55 per share and accrued dividends; will have full voting rights; and will be convertible up to and including December 31, 1933, into the new common stock in the following ratios:

Up to and including December 31, 1931, one share of new common stock for each share of convertible preferred stock;

After December 31, 1931, and up to and including December 31, 1932, one share of new common stock for each one and one-third shares of convertible preferred stock;

After December 31, 1932, and up to and including December 31, 1933, one share of new common stock for each one and two-thirds shares of convertible preferred stock.

A statement of the terms and provisions of the proposed new convertible preferred stock is being forwarded to each stockholder with this letter.

A special meeting of the stockholders of the Company has been called for April 8, 1930, the same day on which the annual meeting will be held, and a proxy and power

EXHIBIT 5 (*Continued*)
WARREN BROTHERS COMPANY
Cambridge, Massachusetts

of attorney covering both meetings is enclosed herewith together with the notices of the meetings.

Stockholders are urged to return their proxies promptly as a two-thirds vote of each class of stock is necessary to accomplish the above reorganization.

By order of the Board of Directors.

In 1931, in order to make common stock available for conversion, the authorized common stock was increased from 600,000 to 1,000,000 shares. The terms by which the convertible preferred stock could be exchanged for common stock are given in Exhibit 5.

FOREIGN BUSINESS

As the company expanded, a substantial part of its business was in foreign countries. This situation placed special burdens on the company's finances and necessitated special financing. The annual report for 1930 contained the following information concerning foreign business:

During the year just closed, your company received awards in nine countries other than continental United States and Canada, viz.: Argentina, Australia, Chile, China, Guatemala, Hawaii, Hungary, Japan and Poland. The aggregate yardage of these awards constitutes 11½% of the total new business received by the company during the year. . . .

The 1932 annual report included the following information about the Cuban contract:

Work on the Cuban Central Highway contract, awarded to this company on February 19, 1927, was completed early in the year 1931 and accepted by the Cuban government on February 24, 1931. The total value of the work involved in the execution of this contract was $72,999,035.07, of which all but approximately $13,000,000.00 was paid in cash or equivalent. Because of the adverse conditions in the securities market, the Cuban government was unable to finance the last $20,000,000.00 of its requirements and it became necessary for this Company to accept at a book value of $11,034,345.00 Cuban 5½% Treasury Notes maturing June 30, 1935, at 95, in partial settlement of which $2,161,659.80 will be used to retire outstanding liabilities. There is also an unpaid balance, including interest, due the Company of $2,616,338.35.

These debts were payable out of Cuban Public Works Tax Fund created especially to service and amortize the indebtedness. If revenues had remained at the 1929 level, the entire indebtedness of $100,000,000 would have been retired within 7 years. If revenues were to remain at the 1932 level, $1,200,000 (estimated), the indebtedness would be retired within 12 years.

1. What general sources of capital did this company use?
2. Were these sources used wisely?
3. Enumerate the various financial instruments used by the company.
4. What were the various changes in capital structure?
5. Were these changes in capital structure justified?
6. How did the character of this company's business affect its financial problems?
7. What bearing did the company's foreign business have on its financial problems?

5. ENSWORTH UTILITY COMPANY

STOCK SALE CAMPAIGNS AMONG CUSTOMERS CONDUCTED BY EMPLOYEES

Toward the end of 1926 the Ensworth Utility Company issued 3,000 shares of $6 preferred stock. Again, early in 1927, another block of 4,000 shares of the same stock was issued. Rather than sell this stock over a wide area through an investment house, the company organized its employees into competitive sales groups instructed to sell the shares in small lots to its customers.

The Ensworth Utility Company had been given a perpetual franchise to provide gas and electricity to a population of 200,000 scattered in 7 towns in an eastern state. The population of these towns varied from 2,000 to 125,000 inhabitants. The gross revenue earned by the company in serving its 35,000 electric customers and 40,000 gas customers averaged, over a period of years, about 20% of its total investment; the yearly net profit after fixed charges and available for dividends ran between 1.5 and 2.5 times the total dividend requirements. Shortly before this campaign the company had merged with a large holding company which controlled the gas and electric properties around the territory served by the Ensworth Company.

To conduct its stock-selling campaign in 1926, 70 selected and approved employees were organized into 7 competitive sales groups, each under a group captain. These groups compiled comprehensive lists of prospective buyers of preferred stock. They were instructed in approved methods of selling preferred stock to customers and employees, met often to discuss any problems which arose, and submitted daily reports on the progress of their work. To each prospective buyer whose name appeared on the group list was sent a sales letter explaining the stock to be issued.

On each share which he sold the individual salesman received a $2 bonus. The group captains were paid 50 cents for each share sold by members of their groups. In addition, many group and

individual prizes were offered. For instance, the salesman selling the greatest number of shares to customers not already owning preferred stock received a $25 bonus; the team selling the most shares was awarded an extra $250.

The salesmen-employees responded well in this sales campaign. Most of the stock was sold to customers and employees of the company; in few instances were customers asked to purchase more than 10 shares of the stock. In the 4 weeks of this first campaign all 3,000 shares of stock were sold.

In February, 1927, the company again offered preferred stock to its employees and customers. Sales groups of employees were organized and directed as in the previous campaign. As an additional incentive, dinners were given once a week to the different sales groups at the company's expense. The second campaign was as successful as the first; the full quota of 4,000 shares of $6 preferred stock was sold in 4 weeks.

Are customers a proper source of funds for a corporation?

6. THE NEW YORK CENTRAL RAILROAD COMPANY

ISSUANCE OF WARRANTS TO SECURE CAPITAL THROUGH THE USE OF CONVERTIBLE BONDS

In February, 1934, The New York Central Railroad Company proposed a plan for the issuance of 10-year, 6% convertible bonds as a means of refunding 2 issues of 4% debentures which would mature in 1934 and of furnishing additional working capital. The directors expected that the debt would ultimately be converted into stock. At the same time the common stock of the company was to be changed from $100-par-value to no-par-value stock. At the time of the announcement of the plan, the stock was selling for about $41 per share on the New York Stock Exchange. Shortly after their issue, 6% convertible bonds were sold at a premium as high as 18½%.

The plan was summarized in a letter to stockholders under date of February 23, 1934, as follows:

> (*a*) Changing the 7,000,000 authorized shares of capital stock of the Company, issued and unissued, into the same number of shares without par value; (*b*) the substitution, share for share, of 4,992,597 40/100 of such shares without par value for the present issued shares; (*c*) increasing the number of authorized shares of capital stock of the Company from 7,000,000 to 10,000,000 shares, all without par value; (*d*) the issue, from time to time, of the resulting unissued 5,007,402 60/100 of such shares without par value in such amounts, on such terms and for such considerations as shall be fixed by the Board of Directors, and empowering said Board, from time to time, to fix such amounts, terms and considerations; (*e*) fixing the stated capital and amount of capital stock of the Company upon and after the proposed change of the stock to shares without par value; (*f*) amendment of the Company's charter to effect such changes and provisions; (*g*) an increase of $59,911,100.00 in the indebtedness of the Company by the issue of that amount of bonds; and (*h*) the pledge of collateral to secure such bonds.

The following information also was contained in the letter from the railroad to its stockholders:

MATURITIES

There will mature on May 1, 1934, $48,000,000, principal amount, of 4% Debenture Bonds of the New York Central and Hudson River Railroad Company (a corporate predecessor of the Company) and $4,500,000, principal amount, of 4% Debenture Bonds (guaranteed as to principal and interest by the Company) of the Boston and Albany Railroad Company, the properties of which are leased to the Company.

THE NEW BOND ISSUE

The Board believes it to be in the interest of the Company to issue bonds convertible into stock, at the option of the holder, in order to provide for these maturities and for other capital purposes, including the retirement of certain equipment trust obligations due in 1934. The Board has therefore approved a plan under which the Company proposes to offer to its stockholders $59,911,100, principal amount, of Ten-Year 6% Convertible Secured Bonds for subscription by them at par to the extent of 12% of the present par value of their several holdings of record of the capital stock of the Company at the close of business on March 5, 1934, *i.e.*, in the ratio of $1,200, principal amount, of bonds for every 100 shares of stock held. The Board has determined that the conversion price for the stock should properly be fixed at $40 per share for the first three years and $50 per share thereafter, *i.e.*, for the last seven years.

CHANGES IN CAPITAL STOCK

The conversion price necessitates changes in the capital stock because each share now has a par value of $100 and cannot lawfully be issued for less. It is therefore proposed to change the authorized capital stock, now consisting of 7,000,000 shares, so as to consist of 10,000,000 shares without par value. 4,992,597 shares of the no-par-value stock will be substituted, share for share, for the present outstanding shares. The remaining shares of authorized stock will be available: (*a*) for conversion of the proposed bonds; (*b*) for the conversion of future convertible bonds that may be issued, with the necessary stockholders' consent; and (*c*) for other capital purposes of the Company, from time to time as occasion may require, at such prices and upon such terms as the Board may determine, without any adjustment of the conversion prices of the presently proposed bond issue. When the proposed change of the capital stock shall have become effective, new no-par-value certificates will be available for issue to the stockholders in exchange for their present par-value certificates upon surrender of the latter; and, pending such exchange, the present certificates will represent the new no-par-value shares.

. . . . . .

TERMS OF THE CONVERTIBLE BONDS

The Ten-Year 6% Convertible Secured Bonds are to be dated May 10, 1934, are to mature May 10, 1944, and are to bear interest payable semiannually in lawful money of the United States of America. They are to be issued under an Indenture, to be executed by the Company and by Guaranty Trust Company of New York, as Trustee, and are to be secured by pledge with the Trustee of the following bonds, the issue and pledge of which are subject to the authorization of the Interstate Commerce Commission:

The New York Central Railroad Company

$48,000,000, principal amount, of The New York Central Railroad Company Consolidation Mortgage 4% Bonds of Series C, due February 1, 1998;
6,000,000, principal amount, of The New York Central and Hudson River Railroad Company First Mortgage 3½% Bonds, due July 1, 1997;
4,500,000, principal amount, of Boston and Albany Railroad Company 6% Refunding Bonds of 1934, due May 1, 1946, guaranteed as to principal and interest by The New York Central Railroad Company;
3,205,000, principal amount, of The Cleveland, Cincinnati, Chicago and St. Louis Railway Company 5% Refunding and Improvement Mortgage Bonds, Series D, due July 1, 1963;
6,171,000, principal amount, of The Michigan Central Railroad Company 4½% Refunding and Improvement Mortgage Bonds, Series A, due January 1, 1947;
7,500,000, principal amount, of The New York Central Railroad Company 5% Refunding and Improvement Mortgage Bonds, Series C, due October 1, 2013.

The Indenture will contain provision for the release of collateral against the deposit of cash or against any retirement of convertible bonds, either upon conversion or redemption.

The bonds are to be convertible, unless sooner redeemed pursuant to the terms of the Indenture, into shares of the proposed no-par-value stock of the Company, from May 11, 1934, to May 10, 1937, inclusive, at the conversion price of $40 per share, *i.e.*, 25 shares of stock per $1,000 Bond, and from May 11, 1937, to maturity, May 10, 1944, inclusive, at the conversion price of $50 per share, *i.e.*, 20 shares of stock per $1,000 Bond.

The bonds are to be made redeemable at the option of the Company, as a whole or in part, on any date prior to maturity upon sixty days' published notice, in the manner to be prescribed in the Indenture, at the following percentages of principal amount, plus accrued interest:

From November 11, 1934, to May 10, 1937, inclusive, at 105%; from May 11, 1937, to May 10, 1940, inclusive, at 102%; from May 11, 1940, to May 10, 1943, inclusive, at 101%; and from May 11, 1943, to May 10, 1944, inclusive, at 100%.

WARRANTS

As soon as practicable after March 5, 1934, warrants are to be mailed to each stockholder specifying the amount of convertible bonds for which he shall be entitled to subscribe. The lowest denomination of bonds will be $100 and no subscription for a less amount will be received. Subscriptions will be received by the Treasurer of the Company until the close of business on May 10, 1934, at which time the right to subscribe will terminate.

Warrants will be of two kinds—(1) Full Warrants entitling the holder to subscribe for bonds to a face amount of $100 or a multiple thereof; and (2) Fractional Warrants which when assembled in appropriate amounts will entitle the holder thereof to subscribe for bonds to the face amount of $100 or a multiple thereof. Warrants will be transferable.

UNDERWRITING

In order to insure that the entire amount of $59,911,100 will be provided for the above-mentioned purposes, the Company expects to conclude arrangements with a group of underwriters and with the Reconstruction Finance Corporation, subject to the approval of the Interstate Commerce Commission, whereby disposition of any such bonds as may not be subscribed for by the stockholders or their assigns under the offer shall be made by sale to such underwriters or pledge to the Reconstruction Finance Corporation, in such proportions as may be agreed upon, on a basis which will provide the funds referred to. More definite information with regard to these arrangements and to temporary provision for the above-mentioned maturities on May 1, 1934, will be contained in the circular to accompany the warrants.

There was considerable objection to these proposed plans for refinancing because it was felt that the terms were too liberal. Specific objections were voiced to the conversion price because New York Central stock generally sold considerably above par and in very profitable years had sold at over $200 a share.

1. What economic and social conditions in February, 1934, might have affected the terms on which the new securities were issued?

2. Why were such liberal terms offered to stockholders to buy the bonds? Should stockholders have purchased the bonds?

3. What were the advantages at that particular time of issuing convertible bonds to secure capital? Was the company wise in deciding to issue convertible bonds?

4. State the advantages and disadvantages of convertible bonds as a means of financing a railroad.

7. EDISON ELECTRIC ILLUMINATING COMPANY OF BOSTON

SOURCES OF FUNDS FOR A WELL-ESTABLISHED COMPANY

Early in June, 1935, the directors of the Edison Electric Illuminating Company of Boston decided to refinance on a long-term basis a substantial portion of the company's outstanding short-term debt. In accordance with this decision the company advertised for bids, which were to be submitted not later than noon on July 15, 1935, for a $53,000,000 issue of 30-year first mortgage bonds. Tenders to purchase the entire issue were received as follows: (1) by The First Boston Corporation for itself and others, for 3½% coupon bonds, 101.913% of par to the company; (2) by Halsey, Stuart & Company for itself and others, for 3½% coupon bonds, 101.837% of par to the company; (3) by Halsey, Stuart & Company for itself and others, for 3.4% coupon bonds, 100.417% of par to the company.

After considerable deliberation on the part of the directors, it was decided to award the issue to The First Boston Corporation syndicate. In this connection a public statement by the president of the company read in part as follows:

> The second tender was rejected, as it would have brought to the company a premium of $40,290 less than that offered by The First Boston Corporation for coupon bonds carrying the same interest rate.
>
> The management and directors gave long and serious consideration to the third tender, carrying a 3.4% coupon. Although this would mean an interest saving of $53,000 a year over the 30-year life of the bonds, the premium offered amounted only to $221,010, as compared with a premium of $1,013,890 offered by the First Boston syndicate. The receipt of nearly $800,000 in additional money at this time would be of great advantage to the company in further reducing the short-term debt still outstanding after the completion of this refunding operation. The management is strongly of the opinion that this advantage more than offsets the interest saving under the lower coupon rate.

Previous to the issuance of the above 30-year bonds it had for some years been the practice of the Edison Electric Illuminating Company of Boston to finance its requirements from the

proceeds of short-term notes.[1] As of December 31, 1934, the company's funded indebtedness consisted of three issues of three-year coupon notes maturing in 1936 and 1937. The first of these, a $16,000,000 issue bearing a 5% coupon rate, dated April 15, 1933, and due April 15, 1936, was noncallable. The remaining two issues, which were in amounts of $35,000,000 and $20,000,000, were dated July 16, 1934, and November 2, 1934, respectively. Each bore a coupon rate of 3% and was callable on not less than 30 days' notice at 100½ and accrued interest if payment was to be made on or before one year after date of issue, at 100¼ if on or before two years after date of issue, or at par thereafter to maturity.

At the time when it was decided by the company to refund its callable short-term debt, a credit agreement was entered into with a group of 15 banks, including the First National Bank of Boston and the Chase National Bank of New York. Because of its unwillingness to call for redemption its 3% coupon notes due July 16, 1936, and November 2, 1937, before it had the funds required for redemption in hand or a firm agreement to provide such funds, and because the postponement of the first call to redeem the notes until after the proceeds of a new issue had been received would have required double interest for a period of at least 30 days, the company sought and secured a bank credit of $53,000,000. Under the credit contract, which was dated June 3, 1935, the group of banks, in consideration of $99,375 paid to them by the company, agreed to make available to the company on its request between July 15 and July 24, 1935, a bank credit of $53,000,000 until October 1, 1937, at an interest rate of 2½% per annum. In accordance with this agreement, the Edison Electric Illuminating Company of Boston borrowed $53,000,000 on July 16, 1935.[2]

Subsequent to the negotiation of the bank credit contract, the company called for redemption the entire issue of coupon notes

[1] The new $53,000,000 issue was reported to be the first issue of long-term first mortgage bonds by any Massachusetts utility company since 1922.

[2] According to a report in the *Wall Street Journal* of June 17, 1935, officials of the Securities and Exchange Commission regarded the use of credit insurance in the case of the Edison Electric Illuminating Company of Boston as unnecessary, inasmuch as there was reasonable assurance that the company's new issue would be disposed of The newspaper report stated that the view of the commission was that credit insurance was sometimes unwisely used, in that protection was purchased when not needed.

due July 16, 1937, at 100¼ and the entire issue of notes due November 2, 1937, at 100½, payments in both cases to be made on July 18, 1935. In order to meet such payments, the company deposited, on July 16, the sum of $55,187,500 with the registrar of both issues, the Old Colony Trust Company of Boston,[1] of which $53,000,000 was borrowed under the bank credit agreement and the balance provided from current funds of the company. On July 19, 1935, therefore, the outstanding funded indebtedness of the company consisted of the $16,000,000 3-year 5% coupon note issue due April 15, 1936, in addition to which were bank loans totaling $53,000,000 due October 1, 1937.

According to the prospectus which was issued in connection with the public offering of the new bonds, the net proceeds to be received[2] by the company from their sale were estimated at $53,713,890 plus accrued interest,[3] after deducting expenses. It was stated that $53,000,000 of this was to be used to retire the company's bank loans, and that the balance would be free treasury funds not yet allocated to any specific purpose. Under the sinking fund provisions of the new issue, the company agreed to pay to the trustee,[4] on or before July 1, 1941, and on or before July 1 in each year thereafter, a sum of money equal to 1% of the maximum principal amount of the bonds which had been at any time theretofore outstanding. This money was to be applied by the trustee to the purchase or redemption of bonds. Such payments might be anticipated by the company. In lieu of money, the company could also deliver bonds to the trustee to be credited at the principal amount thereof on its sinking fund requirements. Redemption provisions of the indenture were stated in the prospectus to be as follows:

The bonds may be called for payment at any time prior to maturity, as a whole or in part, upon thirty (30) days published notice, at the face amount thereof plus a premium of 7½% of the face amount thereof if the redemption date is on or before July 1, 1940; plus a premium of 7% of such face amount if the redemption date is during the one-year period commencing July 2, 1940, and ending July 1, 1941, thereafter decreased by ½ of 1% of such face amount for and during each successive corresponding one-year period to 3½% of such face amount if the

[1] An affiliate of the First National Bank of Boston.

[2] It was stated that temporary bonds would be available for delivery on or about July 26, 1935

[3] The new bonds were dated July 1, 1935.

[4] Trustee for the bonds was the Old Colony Trust Company of Boston.

redemption date is during the one-year period commencing July 2, 1947, and ending July 1, 1948; plus a premium of 3¼% of such face amount if the redemption date is during the one-year period commencing July 2, 1948, and ending July 1, 1949, thereafter decreased by ¼ of 1% of such face amount for and during each successive corresponding one-year period to ¼ of 1% of such face amount if the redemption date is during the one-year period commencing July 2, 1960, and ending July 1, 1961; and thereafter to maturity at the face amount thereof without premium; in each case with accrued interest to the redemption date.

As an electric utility the Edison Electric Illuminating Company of Boston was subject to Massachusetts statutory regulation and to supervision of the Massachusetts Department of Public Utilities. The provisions of the Massachusetts General Laws which applied to the new issue read in part as follows:

> A corporation subject to this chapter may . . . issue bonds at not less than par, to an amount not exceeding its capital stock actually paid in at the time of such issue and applied to the purposes of the corporation, increased by all cash premiums paid to the corporation thereon and likewise so applied, and bearing interest at such rate as the department shall approve . . . and may secure the payment of the principal and interest of said bonds by a mortgage of its franchise and property. . . .
>
> Gas and electric companies shall issue only such amount of . . . bonds . . . as the department may from time to time vote is reasonably necessary for the purpose for which such issue of . . . bonds . . . has been authorized. . . .
>
> A gas or electric company, under the supervision of the department, issuing bonds under the two preceding sections, shall invite proposals for the purchase thereof by advertisements in two or more newspapers published in the city or town where it is situated, if there be such, and in two or more newspapers published in Boston. It may, however, reserve the right to reject any and all bids. If no such proposal is accepted, it may sell the whole or any part of the bonds to any persons or corporations in such manner, at such times, and upon such terms, but in no case at less than the par value thereof to be actually paid in cash, as its directors shall determine.[1]

In accordance with the above statute, the company secured the approval of the Massachusetts Department of Public Utilities to the issuance of new bonds at a coupon rate not exceeding 3¾% per annum. After the issue was authorized by the company's stockholders and board of directors, proposals were invited through newspaper advertisements for the purchase of the bonds.

[1] Chap. 164, Secs. 13, 14 and 15 (Tercentenary Edition)

As permitted by the statute, the company reserved the right to reject any or all bids.

Members[1] of the purchase group to which the new issue was awarded and their respective firm commitments were as follows:

Name	Address	Amounts severally underwritten
The First Boston Corporation	Boston, Mass.	$10,600,000
Lee Higginson Corporation	Boston, Mass.	5,800,000
F. S. Moseley & Company.	Boston, Mass.	5,600,000
Kidder, Peabody & Co	Boston, Mass.	4,200,000
Brown Harriman & Co., Inc	Boston, Mass.	3,800,000
Burr, Gannett & Co.	Boston, Mass.	3,600,000
White, Weld & Co.	Boston, Mass.	2,325,000
Goldman, Sachs & Co.	New York, N. Y.	1,675,000
Hornblower & Weeks	Boston, Mass.	1,525,000
Stone & Webster and Blodgett, Inc.	Boston, Mass.	1,525,000
Estabrook & Co.	Boston, Mass.	1,525,000
R. L. Day & Co	Boston, Mass.	1,525,000
Hayden, Stone & Co	Boston, Mass	1,125,000
Paine, Webber & Co.	Boston, Mass.	1,125,000
Jackson & Curtis.	Boston, Mass.	1,125,000
Tucker, Anthony & Co	Boston, Mass.	825,000
Coffin & Burr, Inc.	Boston, Mass.	825,000
Whiting, Weeks & Knowles, Inc.	Boston, Mass	825,000
Spencer Trask & Co.	Boston, Mass.	825,000
Arthur Perry & Co., Inc.	Boston, Mass.	825,000
H. M. Byllesby Co., Inc.	New York, N. Y.	750,000
Blake Bros. & Co.	Boston, Mass.	600,000
Newton, Abbe & Co.	Boston, Mass.	450,000

1. What were the sources of funds used by the company?
2. How were the sources reached?
3. Was the credit rating of this company high? What evidence is there leading to your answer?

SUMMARY QUESTIONS

1. What are the risks involved in furnishing funds for a new venture?
2. What factors should determine the return on new capital?
3. What are the chief ways of securing funds for a new concern?
4. What sources may be used in securing funds for a going concern?

[1] According to the prospectus, none of the underwriters was affiliated with the company, except one of the partners of Burr, Gannett & Co., who was a company director.

5. What determines the type of security to be issued in exchange for new funds in a going concern?

READINGS

DEWING, A. S. *The Financial Policy of Corporations.* 3d rev. ed. New York: Ronald Press Company, 1934. Book III: "Promotion," Chap. 1: "The Promoter," pp. 245–268; Chap. 2: "The Procedure of Promotion," pp. 269–301; Chap. 3: "Fundamental Principles Determining the Financial Plan," pp. 302–311.

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IV

MANAGEMENT OF WORKING CAPITAL

Possibly nowhere in the realm of financial management are the administrative problems more difficult or more important than in the careful handling of working capital. It is here that the financial officer must keep in close touch with all the operations of the corporation, for working capital is represented by current assets which are continually changing from day to day as they are utilized. Working capital consists of cash or its equivalent, receivables, and those materials necessary to a plant's operation, as distinguished from the fixed investments in real estate, plant, and machinery. Normally working capital enters the business in the form of cash contributed by owners, borrowed from banks, or received from the sale of goods. Excess funds from the latter source may be distributed to the owners, but the wise administrator first withholds the amounts needed for continuing operation with a safe margin.

To plan effectively, the officer controlling the finances of a corporation must have an intimate knowledge of the corporation's financial needs and of the plans and objectives of its operating executives. The financial officer's problem in the administration of working capital is twofold. On the one hand he must keep track of working capital and supervise accounting which provides the company with valuable records; on the other hand he must plan for the future and prepare a budget. Close cooperation with his associates and constant study of all those conditions which affect his company are essential to guide him in providing for the unforeseen.

At the outset the chief executives must formulate certain policies of operation which may have significant bearing on working capital requirements. Some businesses adopt a policy of handling their inventory of raw materials on a hand-to-mouth basis—in other words, of never having on hand more materials and supplies than are required for current operations. The

working capital requirements of such a business differ widely from those of a business which has adopted a policy of accumulating stocks of raw materials and supplies in periods of apparent low prices or market reactions. The number of items in a line, as well as the cost of individual items, affects the amount of funds which must be invested in inventories. Particularly in seasonal businesses, where production and consumption seldom can be synchronized, working capital is tied up in inventories pending orderly marketing throughout the year. In some types of business the length of time required to process raw materials has an important bearing on working capital problems. The raw material of a leather company, for example, may be in process from four to six months, whereas that of a candy company, chiefly sugar, is always available and can be transformed into finished products within a short space of time. The amount of seasonal borrowing from banks determines the amount of working capital which must be kept on deposit to meet the requirements of the banks. The extent to which a company makes advances to raw material producers and the extent to which it grants credit to its customers also affect the working capital needs. Advertising expenditures must likewise be taken into account.

With policies established on the foregoing considerations, specific plans can be made for the working capital requirements of the business. In large concerns, the financial officer relies on various budgets, which are estimates of the requirements and results of operations under various assumed conditions. It is customary for the sales manager to submit estimates of the quantities of goods which he believes could be sold at various prices. From an analysis of these figures production and pricing decisions are made from which the financial officer can begin his attack on working capital needs. The production manager presents cost estimates for the manufacturing processes. The purchasing agent presents a budget of his requirements to supply the business with the necessary raw materials and supplies. Additional expenses, such as interest, salaries, insurance, freight, and selling costs, are then added to the working capital requirements for the ensuing period. The financial manager must allow also for what he considers will provide a safe margin of liquid funds to meet contingencies and to allow for changing prices or markets.

The financial officer will next devote his attention to the sources upon which he can rely to supply these requirements. He knows the amount of cash on hand and the value of the receivables and inventories. He knows also the terms and schedules of payments which he will have to meet. He studies the turnover of accounts receivable and of inventory, those items whose conversion into cash replenishes liquid funds. He considers, too, the extent to which the banks can be relied upon to furnish temporary working capital.

One of the duties of the officer in charge of the administration of working capital is, of course, the establishment and maintenance of necessary sources for bank loans. He must work closely with the banks, keeping them in touch with his concern's affairs and with its plans for the future. The relationship between a company and its banks involves much more than the mere exchange of figures. Obviously the banker is interested in the financial statements, the significant ratios, and the other financial analyses which are available. Figures in formal array on balance sheets and income statements are, however, historical figures, and their significance as an aid in reaching a sound conclusion regarding the future of the company can be determined only by the use of additional information.

A banker consequently wants to know the character, methods, and objectives of the executives in charge of the concern which applies for a loan. He also wants to know for what purpose the company wishes to obtain funds and what other means of securing the necessary funds are open to the company. Intimate contact and frank discussion are, therefore, important in maintaining satisfactory relationships with banks. In fact, all problems connected with the control of working capital involve a study of conditions, plans, and objectives quite distinct from the analyses of historical tables and charts.

The administration of working capital sometimes involves problems concerning disposition of an excess of cash resulting either from increased profits, changes in production processes, or the liquidation of other assets. Before a sound policy can be adopted for handling these funds, careful judgment of future conditions must be exerted. The officer may decide to conserve the cash for future contingencies, to invest it in securities of other companies or of the government, to buy inventories in advance

of requirements, to propose an expansion program for the company, to suggest the retirement of outstanding liabilities such as bonds or preferred stock, or to return excess funds to the owners as extra dividends. His decision will be influenced to a large extent by whether or not he believes this excess is the result of conditions which are permanent rather than temporary.

From the collection of facts, opinions, and judgments, from the budgets, plans, and proposed policies, the financial officer must draw up his own financial budget showing estimated expenses, estimated income, and estimated borrowings or plans for investment. Constant vigilance is required to ascertain whether or not events are transpiring as predicted. Modifications must be made to meet the constantly changing conditions, to adjust to new market situations, to new demands from the trade, and to new production methods and processes.

1. OLIVER PAINT & VARNISH COMPANY

REDUCTION OF BANK LOANS

The Oliver Paint & Varnish Company, incorporated in Ohio in 1881, manufactured paints, varnishes, enamels, dryers, and metal and roof coatings in its plant at St. Louis. It also owned all the capital stock of three paint companies with plants at Cleveland, Ohio; Chicago, Illinois; and Kansas City, Missouri. It maintained branch offices and warehouses in St. Louis, Cleveland, New York City, Boston, Philadelphia, San Francisco, Atlanta, and Chicago, from which salesmen operated and deliveries were made. The company sold its products largely to hardware dealers throughout the country. Its paints and varnishes always had had a high standing in the trade, although "Oliver" products had not been effectively advertised.

During 1920 the company had experienced an abnormal demand for its products and, because of its difficulty in obtaining sufficient supplies of materials to permit efficient manufacturing operations, had been obliged to contract for its raw materials months in advance. A contributing factor to this unusual situation was the difficulty in obtaining prompt freight shipments due to railroad congestion. By the end of 1920 the company had contracted for thousands of dollars worth of raw materials and had inventories of over $800,000 which it had financed largely through bank borrowings aggregating $960,000 at their peak in December, 1920. Of this amount the Hood National Bank had loaned $400,000.

The company's executives had realized the danger of large future commitments at inflated prices but had deemed forward buying advisable inasmuch as they felt obliged to provide for the orders of their customers, many of whom had purchased their paint and varnish requirements from the company for many years. When paint and varnish prices declined in early 1921, however, the company suffered severe inventory losses, and many of its customers failed, involving the company in additional credit losses.

Operations for the year 1921 showed a loss of about $350,000, and the company passed its preferred dividend in July, 1921. Operations during 1922, 1924, and 1926 resulted in further losses, while small profits were shown in 1923 and in 1925, as indicated in Exhibit 1.

EXHIBIT 1
OLIVER PAINT & VARNISH COMPANY
Income Account, Years Ended August 31
(In thousands of dollars)

	1920	1921	1922	1923	1924	1925	1926	1927
Net sales....	$2,813	$2,088	$1,900	$2,028	$1,732	$1,829	$1,651	$1,934
Total income..	2,831	2,098	....	2,034	1,740	1,837	1,657	1,909
Cost of sales......	1,687	1,494	....	1,113	1,040	994	950	1,138
Gross profit.......	$1,144	$ 604	....	$ 921	$ 700	$ 843	$ 707	$ 771
Expense.......	869	818	......	755	663	674	633	639
Other deductions....	83	95	....	76	62	56	50	6
Net income before Federal taxes.....	$ 192	$ 309[d]	...	$ 90	$ 25[d]	$ 113	$ 24	$ 126
Provision for taxes and contingencies	52	41	....	33	73	62	45	110
Net profit......	$ 140	$ 350[d]	$ 25[d]	$ 57	$ 98[d]	$ 51	$ 21[d]	$ 16

[d] Deficit.

In 1926 the company reorganized its sales force, advertised its "Oliver" brand extensively in national periodicals, began the manufacture of a more complete line of paints and varnishes, and entered the industrial paint and varnish field more aggressively. It sold large quantities of paints and varnishes to important industrial concerns during 1926 and 1927. Although there was little profit in this type of business it provided a volume of sales which enabled the plants to operate at capacity, thus reducing unit overhead charges and production costs.

As a result of improved conditions in the industry and changes made in its merchandising methods, the company showed a net profit of about $16,000 for 1927 and considered resuming the dividend on its preferred stock which then had 45½% of accumulations outstanding. The company had reduced its bank borrowings gradually until this indebtedness amounted to $339,000 as of August 31, 1927 (see Exhibit 2). Of this amount the Hood National Bank had advanced $240,000. Peak borrowings in 1927 had amounted to $432,000. The company anticipated

asking the Hood National Bank for an additional $80,000 loan early in 1928 to increase working capital.

EXHIBIT 2

OLIVER PAINT & VARNISH COMPANY

Consolidated Balance Sheet, as of August 31

(In thousands of dollars)

	1920	1921	1922	1923	1924	1925	1926	1927
ASSETS								
Cash	$ 106	$ 102	$ 87	$ 85	$ 70	$ 42	$ 45	$ 50
Notes Receivable	2	13	.....	.....	. .	20	12	14
Accounts Receivable	851	582	786	702	618	538	452	590
Inventories, Less Reserve	825	478	467	516	475	500	506	523
U.S. Securities	22	12	. . .	.	. . .	....	.. .	. . .
Total Current Assets	$1,806	$1,187	$1,340	$1,303	$1,163	$1,100	$1,015	$1,177
Land, Buildings, and Equipment Less Depreciation	474	462	447	439	357	355	373	374
Notes Receivable—Organization Expense	......	......	17	15	14	14	12	11
Notes Receivable for Sale of Capital Stocks	65	54	46	32	91	91	90	87
Other Assets	27	27	......	......	27	16	11	13
Goodwill, Patents, and Trade-Marks	.. ...	... ..	......	1	1	1	1	1
Deferred Charges	87	101	99	118	90	90	95	104
Due from Subsidiaries	.. . .	.	37	37	. .	..	. .	. ..
Total Assets	$2,459	$1,831	$1,986	$1,945	$1,743	$1,667	$1,597	$1,767
LIABILITIES								
Notes Payable to Banks	$ 660	$ 530	$ 576	$ 594	$ 489	$ 405	$ 364	$ 339
Notes Payable for Paper Sold	10	..	78	54	61	62	....	....
Accounts Payable—Trade	299	137	190	116	76	57	74	154
Accounts Payable—Subsidiaries	... .	.....	.....	......	9	. ...	10	6
Accounts Payable—Others	....	. ..	.....	.....	7	......	19	29
Accrued Liabilities	7	10	8	9	40	7	9	} 21
Reserve for Federal Taxes	52	.....	......	.....	... ..	.. ...	21	}
Reserve for Salesmen's Commissions	.... .	4	4	. ...	......	59	.	.. . .
Total Current Liabilities	$1,028	$ 681	$ 856	$ 773	$ 682	$ 590	$ 497	$ 549
Reserves	3	16	32	32	29	....	45	67
Stock of Subsidiary Companies	12	10	10	10	10	10	10	10
Preferred Stock	590	591	605	598	589	583	582	582
Common Stock	462	463	439	430	430	430	430	430
Surplus	364	70	44	102	3	54	33	129
Total Liabilities	$2,459	$1,831	$1,986	$1,945	$1,743	$1,667	$1,597	$1,767
Net Worth	1,428	1,134	1,098	1,140	1,032	1,077	1,055	1,151
Working Capital	778	506	484	530	481	510	518	628
Current Ratio	1.76	1.74	1.57	1.69	1.70	1.86	2.04	2.14

In early 1928 the company was manufacturing about 500 separate products, including plain and colored varnishes of all kinds, enamels, colors in oil, shingle stain, automobile, wall, cement, and concrete finishes, and paints of all kinds. The company's customers consisted largely of about 10,000 hardware dealers who sold its products on an exclusive agency basis.

Many of these dealers had carried the company's products for 20 to 25 years. The executives stated that the company could secure other dealers to sell Oliver products on an exclusive agency basis inasmuch as it was able to offer a full line of high-grade, widely advertised paints and varnishes. It also planned to extend its South American and foreign business extensively in 1928.

In analyzing the company's financial statement, the Hood National Bank made use of the average financial ratios of paint manufacturers prepared by the Robert Morris Associates for the year ending December 31, 1925. The selected ratios compared with those of the company for 1927 were as follows:

Ratio	1925 Robert Morris Associates Averages of Paint Manufacturers	1927 Oliver Paint & Varnish Company
Current	3 10	2.14
Merchandise to Receivables	1.10	0.87
Net Worth to Fixed Assets	1.45	3 08
Net Worth to Total Debt	2.40	2.10
Sales to Receivables	5.70	3.20
Sales to Merchandise	4.70	3.70
Sales to Fixed Assets	3.50	5.19
Sales to Net Worth	1.91	1.68

This comparison indicated that the company was not obtaining a large enough volume of sales in proportion to its investment. Its indebtedness was also heavy and its current and cash position unsatisfactory. Its current position as of January 31, 1928, as compared with the corresponding date of the previous year, is shown in the table at the top of page 100.

The company's executives wished to resume preferred dividends as soon as possible in order to maintain the goodwill of the preferred stockholders. They also wished to maintain favorable relations with the company's depository banks and especially with the Hood National Bank, which had loaned the company its legal limit of $400,000 at various times. The company had, in its turn, liquidated bank loans regularly, and maintained adequate balances.

	1927	1928
Cash	$ 41,456	$ 44,874
Receivables	548,643	611,577
Inventories	579,432	619,987
Total Current Assets	$1,169,531	$1,276,438
Notes Payable	$ 384,000	$ 409,600
Accounts Payable	235,445	271,730
Total Current Liabilities	$ 619,445	$ 681,330

1. What were the working capital problems faced by the company in 1928?

2. What should the officers of the company have decided about the payment of preferred dividends?

3. Outline sound working capital policies for the company.

2. HILTON COMPANY

ADMINISTRATION OF EXCESS WORKING CAPITAL

In February, 1935, the president of the Hilton Company planned to ask the banks to extend again the major portion of the company's notes, amounting to over $1,000,000, which would fall due on May 1 of that year. Inasmuch as his company had been heavily in debt to four large banks since 1925, he had reason to believe that two of the four banks holding these notes would hesitate to continue their loans. Before approaching the banks, however, he requested that his treasurer review the need for working capital and the handling of it during the period, 1927 to 1935.

The Hilton Company, located in Michigan, was internationally famous for its engineering staff and for the high quality of automatic tool machinery which it produced. In the early 1920's, when its credit standing was extremely high, the company had started an ill-advised expansion program. By 1927, the company owed over $4,500,000. Of this amount, about $3,500,000 was loaned by banks and $1,000,000 by stockholders in the company. When the bankers realized the seriousness of the situation, they decided that only by changing the management and aiding the company could they recover their investment. It was estimated that if the banks had attempted to force payment in 1926, they would have received less than 30 cents on each dollar of their loans.

The president who assumed office in 1927 insisted every time the question of working capital arose that the company needed substantial working capital at all times. He pointed out that companies in this industry could not contract and expand expenses, particularly wages and salaries, in close conformity with fluctuations in production and sales. Because the company manufactured many types of machinery, complex technical problems necessitated the company's maintaining a large group of men trained in engineering production and selling. This staff, the president believed, was one of the greatest assets of the company.

From 1927 to 1935, the company made a profit in only a few years, as shown by Exhibit 1. Because of the decrease in annual sales a minimum of working capital was tied up in receivables and inventory in 1932. Consequently the president had been able to reduce the loans from about $4,500,000 in 1927 to about $2,000,000 in 1932. From then until 1935 loans had been reduced less than $150,000. It had been the president's policy to pay off a small portion of the notes from time to time as working capital became more than adequate, and then when the notes fell due to make an additional payment. The balance was extended for two or three years, depending on his negotiations with the banks. The company reduced chiefly the loans from banks so that in 1935 the total amounts owed banks and individuals were about equal. For these loans the company was paying 5½% to 7% interest.

EXHIBIT 1
HILTON COMPANY
Net Sales, Operating Profit, and Income, Years Ended December 31
(In thousands of dollars)

Item	1926	1927	1928	1929	1930	1931	1932	1933	1934
Annual sales	$4,446	$5,315	$3,540	$6,583	$3,072	$2,775	$1,487	$2,788	$4,867
Net operating profit*. .	†	†	†	†	†	127[d]	344[d]	336	672
Net income. .	†	†	670[d]	753	668[d]	364[d]	571[d]	171	389

* After depreciation but before interest.
† Data not available.
[d] Deficit.

The bankers were anxious to have their loans repaid, and had commented several times to the president that in their opinion cash reserves were too high, with the result that an unnecessary amount of interest was being paid in order to have such a strong working capital position. A table showing for the year 1934 monthly sales, domestic orders received, payments for materials, and pay roll, is given in Exhibit 2. Balance sheets, as of December 31, 1926 through 1934, are shown in Exhibit 3.

The president defended his position by showing why a large amount of working capital was necessary. Most manufacturing, he said, was to specifications. As each order was received, it was the policy of the company to buy material sufficient to meet most of the manufacturing requirements of that order. It took at least six to eight weeks to start shipping a fair-sized order

after it had been received. Since pay roll costs exceeded the costs of material, the cost of "work in process" made a considerable addition to inventory.

EXHIBIT 2
HILTON COMPANY
Monthly Sales, Domestic Orders Received, Payments for Materials, and Pay Roll, for the Year 1934

1934	Total sales (deliveries)	Domestic orders received*	Cash payment for materials	Pay roll
January	$ 361,045	$ 449,388	$ 106,613	$ 165,463
February	408,247	254,130	136,109	156,899
March	432,838	171,175	185,724	177,594
April	451,162	449,335	203,214	170,647
May	495,070	193,682	221,539	199,401
June	559,896	27,076	277,951	189,759
July	277,540	34,113	84,580	132,701
August	434,584	34,384	123,982	156,983
September	262,211	309,736	87,677	124,802
October	358,996	49,580	114,106	153,968
November	358,350	82,689	93,592	123,772
December	467,463	78,580	152,126	127,024
Grand Total	$4,867,402	$2,133,868	$1,787,213	$1,879,013
Monthly Average	$ 405,617	$ 177,822	$ 148,934	$ 156,584

* Total orders received:

Domestic	$2,133,868
Repairs	929,891
Foreign	696,754
Grand Total	$3,760,513
Monthly average of total orders received	$ 313,376

The president also pointed out that complete shipments could seldom be made. Customers were rarely able to handle a complete order at one time because of its bulk. Furthermore the Hilton Company was responsible for setting up the machinery on the premises. The installation of machinery and the training of operators had to be done by skilled men, the number of whom was limited in the reduced organization.

Although the terms of the Hilton Company were net cash 30 days from date of delivery, it was at least six weeks after the shipment had been made before the Hilton Company received payment. Customers were inclined not to pay for machinery until a sufficient amount was running satisfactorily. Losses from bad debts, however, had been less than 0.1% annually since 1927.

EXHIBIT 3
HILTON COMPANY
Balance Sheet and Selected Ratios, as of December 31
(In thousands of dollars)

	1926	1927	1928	1929	1930	1931	1932	1933	1934
ASSETS									
Cash	$ 763	$ 574	$ 745	$ 778	$ 756	$ 870	$ 399	$ 245	$ 703
Short-term Investments (see Exhibits 4 and 5)	....	865	891	254	675	652	....	....	....
Notes and Accounts Receivable, Less Reserve	2,450	2,285	1,975	2,079	1,051	1,110	809	1,257	1,094
Inventories, at Lower of Cost or Market	1,760	1,298	1,244	1,569	893	629	522	1,080	883
Land, Buildings, Machinery, and Equipment, Less Depreciation	5,248	4,959	3,856	3,705	3,580	3,364	3,400	3,282	3,182
Total Assets	$10,221	$9,981	$8,711	$8,385	$6,955	$6,625	$5,130	$5,864	$5,862
LIABILITIES									
Notes and Accounts Payable	$ 4,776*	$ 560	$ 643	$ 361	$ 120	$ 219	$ 128	$ 710	$ 474
Special Loan†	....	....	....	....	....	....	235	225	197
Notes (Due May 1, 1935)	....	4,551	4,551	3,589	3,130	3,077	2,065	2,051	1,934
7 % Preferred Stock	2,920	2,920	2,920	2,920	2,920	2,920	2,920	2,920	2,920
Common Stock and Surplus	2,525	1,950	597	1,515	785	409	218[d]	42[d]	337
Total Liabilities	$10,221	$9,981	$8,711	$8,385	$6,955	$6,625	$5,130	$5,864	$5,862
Accumulated Dividends on Preferred Stock	$ 307	$ 511	$ 715	$ 920	$1,124	$1,329	$1,533	$1,738	$1,942
RATIOS									
Total Current Assets to Total Current Liabilities	1.04	8.97	7.55	12.96	28.13	14.89	13.52	3.64	1.11
Total Current Assets, Less Inventories, to Total Current Liabilities	0.67	6.65	5.62	8.62	20.68	12.02	9.44	2.12	0.75
Net Working Capital to Sales	0.04	0.84	1.19	0.66	1.06	1.10	1.08	0.67	0.06
Net Working Capital to Total Assets	0.02	0.45	0.48	0.52	0.47	0.46	0.31	0.32	0.05
Sales to Inventory	2.53	4.09	2.85	4.20	3.44	4.41	2.85	2.58	5.51
Net Worth to Total Liabilities‡	0.53	0.49	0.40	0.53	0.53	0.50	0.53	0.49	0.56
Collection Period§ (days)	201	157	204	115	125	146	199	165	82

* Includes $3,017,143 Notes Payable Plus Accrued Interest.
† This loan for the purpose of modernizing manufacturing equipment was made by others than previous noteholders. It was payable in annual installments.
‡ Common stock, preferred stock and surplus to total liabilities.
§ Notes receivable were included with accounts receivable in determining the collection period.
[d] Deficit.

By planning purchases, deliveries, and production in accordance with available cash, the minimum cash balance on which the company could operate, the president said, was $300,000. He stated that he believed it necessary to provide not only for current needs but for any sudden demand for the company's products. Furthermore, the Hilton Company was obliged to carry accounts with each of the creditor banks. It also carried a substantial balance elsewhere to avoid paying exchange costs, and a satisfactory balance in the local banks from which pay rolls were obtained.

EXHIBIT 4
HILTON COMPANY
Description of Balance Sheet Items Affecting Working Capital
(In thousands of dollars)

Jan. 1 to Dec. 31	Current Assets (excluding short-term paper)			Current Liabilities			
	Cash	Receivables*	Inventory†	Accounts payable	Prior year's Federal taxes	Miscellaneous	Two-to-five-year notes
1927 Maximum....	$ 890	$2,459	$1,885	$175	$432	$130	$4,551
Minimum.....	411	1,568	1,298	95	418	5	4,551
1928 Maximum.....	745	2,285	1,331	158	440	91	4,551
Minimum.. .	333	1,119	1,129	106	418	35	4,551
1929 Maximum.....	949	2,413	1,570	165	445	137	4,551
Minimum.....	371	1,439	1,244	91	..	89	3,589
1930 Maximum.....	885	2,079	1,570	157	..	189	3,589
Minimum....	580	735	893	32	......	139	3,130
1931 Maximum.. .	870	1,254	893	88		192	3,130
Minimum......	608	703	629	32	.. .	97	3,077
1932 Maximum....	1,128	1,110	670	81	. .	92	3,077
Minimum. .	297	491	494	22	..	37	1,985
1933 (Dec. 31).. ..	245	1,257	1,080	156	. .	. . .	2,051
1934 (Dec. 31)....	703	1,094	883	182	.. .	......	1,934

* Prime Receivables.
† Raw materials in the inventory were carried at cost or market, whichever was lower. Much of the inventory was in spare parts.

The president had followed a very definite and conservative policy in the use of excess cash (see Exhibits 4 and 5). He consulted with his bankers constantly. Cash was placed only in investments on which he and the bankers were sure payment would be made when due. In the period, 1927 to 1929, the president could have invested in common stocks, as the managers

EXHIBIT 5
HILTON COMPANY
Short-Term Investments
(In thousands of dollars)

Jan. 1 to Dec. 31	Certificates of deposit	Acceptances	Short-term municipals	Rate of returns received, per cent	
				High	Low
1927 Maximum	$300	$ 565	...	3.75	2.50
Minimum	300	...	...		
1928 Maximum	300	1,149	...	5.00	2.00
Minimum	300	565	...		
1929 Maximum	300	991	...	5.63	2.00
Minimum	...	239	...		
1930 Maximum	675	685	...	4.13	2.00
Minimum	...	...	...		
1931 Maximum	675	291	$ 83	4.25	2.00
Minimum	278	...	...		
1932 Maximum	278	505	557	5.90	2.00
Minimum	...	...	...		

of many industrial companies were doing. During that period, so-called "blue-chip" common stocks more than doubled in price. In 1931 and 1932 he could have invested in high-grade bonds and stocks which by 1935 would have appreciated greatly. In 1933 when inventory prices were very low and talk of inflation was rampant, he did not invest heavily in inventory as some of his competitors did. In 1933, at the request of the creditor banks, the president began to carry all surplus funds with them. From 1933 to 1935 interest received on these bank balances was negligible.

1. What policies did the president of the Hilton Company pursue in regard to working capital?

2. Was the president wise in keeping such a large amount of cash in the business?

3. Were his relations with the banks such as to secure their confidence?

4. Should the banks have extended the notes at his request?

5. To what extent did the type of business of the Hilton Company affect the company's working capital requirements?

3. HAMMOND MANUFACTURING COMPANY

LOAN TO INDUSTRY BY RECONSTRUCTION FINANCE CORPORATION[1]

Early in 1935 the Hammond Manufacturing Company applied to the Reconstruction Finance Corporation for a loan of $750,000. The company had been in receivership for about a year. New funds were required to bring about reorganization and to permit continued operation. City taxes were overdue and purchase of materials could be made only if a substantial amount of credit were advanced by trade creditors who were loath to do so because of the Hammond Manufacturing Company's financial condition. The R.F.C. had to decide whether or not to loan to the company, and if so, on what conditions.

The company produced only high-quality furniture and was favorably regarded by the trade for the style and quality of its products. Furniture manufactured by the company was distributed nationally to the better retail outlets. The company's plant was located in a middle western city.

In 1930 depressed business conditions adversely affected the company's sales volume. Consumers were changing their purchases from high-price to low-price furniture, and this condition was intensified as the depression became worse. Because costs were not materially reduced, large operating losses resulted. Sales and income for the years 1925 through 1934 are shown as Exhibit 1.

Working capital was depleted by sinking fund payments of $200,000 annually on $4,500,000 in debentures issued in 1927. The company resorted to bank borrowings. The banking disorders of 1932 and 1933, however, forced the company's banks to demand repayment of their loans. Repayment of the bank loans further weakened the company's cash position. In December, 1933, the sinking fund payment was defaulted, and in March, 1934, the company was placed in receivership. In order to meet current financial requirements during the year 1934, an arrangement was

[1] For a brief discussion of loan policies of the Reconstruction Finance Corporation, see Appendix III, p. 359.

EXHIBIT 1

HAMMOND MANUFACTURING COMPANY

Income Statement (Obtained by the Reconstruction Finance Corporation), Years Ended August 31

(In thousands of dollars)

	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934	1934 Sept. 1 to Dec. 1
Net sales	$14,283	$12,320	$11,703	$10,253	$8,462	$6,155	$3,422	$1,283	$1,964	$2,546	$926
Gross profit	4,286	3,314	3,374	2,507	2,582	503	230[d]	344[d]	650	282	45
Depreciation	164	182	198	228	258	264	330	306	291	117	21
Net profit	2,444	1,376	1,410	416	411	1,358[d]	2,042[d]	2,049[d]	527[d]	476[d]	77[d]
Dividends or withdrawals	3,267	720	2,070	4,707	0	0	0	0	0	0	0

[d] Deficit.

made to discount current receivables with an individual interested in the company.

When the plan of reorganization was proposed, in April, 1935, the company's major obligations comprised $2,606,250 of 5% debentures plus accrued interest, $99,223 in accounts payable for merchandise, and $262,500 in overdue city taxes. The reorganization plan provided for the issue of 300,000 shares of $10-par preferred stock in payment of the debentures and other unsecured claims. New capital was necessary for a reorganization.

Information regarding loans to industry was given in the Reconstruction Finance Corporation Act, Section 5d, as follows:

> For the purpose of *maintaining and increasing the employment of labor* the Reconstruction Finance Corporation is authorized to make loans, when so secured as reasonably to assure repayment, to solvent industrial businesses, . . . when credit at prevailing bank rates for loans of the character applied for is not otherwise available at banks.

It was further provided that such loans were to mature not later than January 31, 1945, and that any additional terms or restrictions which the R.F.C. might determine would have to be accepted.

The R.F.C. made a thorough examination of the Hammond Manufacturing Company. The application form filled out by the company was checked in detail. Condensed income statements and balance sheets are shown as Exhibits 1 and 2. Exhibit 2 includes the pro forma balance sheet drawn up by the company for the R.F.C., giving effect to the proposed loan and reorganization plan. The company's physical assets were carefully appraised, and its standing in the trade was investigated.

The R.F.C. considered carefully not only how secure such a loan would be, and how it would affect the company, but also how it would affect employment. Total employees of the Hammond company then numbered 1,176; the R.F.C. felt that increased operations facilitated by the adequate working capital would increase the number employed to about 1,400. Liquidation would of course involve the release of all the employees. Since the company's pay roll amounted to $900,000 in 1934, liquidation would seriously affect the community.

If the loan were made, the R.F.C. would have to prescribe stringent conditions. Ample collateral would be necessary. First and chattel mortgages on fixed assets would provide security

for $600,000 of the proposed loan, and enough receivables and inventories would be pledged to cover the remaining $150,000. Furthermore, certain individuals interested in the company would be required to lend $375,000 if it were needed. Pledge of receivables and inventories to these individuals would secure this advance to the company.

EXHIBIT 2
HAMMOND MANUFACTURING COMPANY
Selected Balance Sheets

	As of Aug. 31 1932	As of Aug. 31 1933	As of Dec. 1 1934	As of May 4 1935	Pro forma assuming R.F.C. loan granted
ASSETS					
Cash	$ 186,259	$ 73,416	$ 23,696	$ 3,300	
Securities	925,920	361,416			
Trade Receivables	248,979	578,738	77,940	658,094	
Inventory	1,458,668	1,351,671	1,239,726	1,323,390	
Total Current Assets	$2,819,826	$2,365,241	$1,341,362	$1,984,784	$1,632,926
Fixed Assets	5,505,492	5,234,502	4,650,318	5,109,219	4,650,318
Other Assets	144,964	25,443	503,685	27,498	503,685
Patents	182,171	1		1	
Deferred	94,809	14,004		9,660	
Total Assets	$8,747,262	$7,639,191	$6,495,365	$7,131,162	$6,786,929
LIABILITIES					
Notes Payable	$ 750,000	$ 750,000		$ 543,600	
Accounts Payable	196,764	103,796	$ 280,621	270,106	
Accrued Items	56,453	155,143	272,543	32,510	
Tax Reserve				296,184	
Total Current Liabilities	$1,003,217	$1,008,939	$ 553,164	$1,142,400	None
Reserves		71,841			
10-year 5 % Debentures due 1937	3,113,250	2,606,250	2,640,276	2,742,602	
R.F.C. Loan					$ 750,000
Capital—100,000 Shares No-par Common	4,630,795	3,952,161	3,301,925	3,246,160	6,036,929*
Total Liabilities	$8,747,262	$7,639,191	$6,495,365	$7,131,162	$6,786,929

* Includes 300,000 shares of $10-par preferred stock.

The R.F.C. insisted that the loan of $750,000 be used for working capital. It directed that not more than $150,000 was to be used for overdue taxes and not more than $22,500 for new machinery. The R.F.C. insisted that net working capital be maintained at not less than $600,000.

The loan would be granted only after the company was discharged from bankruptcy. The R.F.C. would approve the proposed plan of reorganization upon condition that all the requirements of the R.F.C. were satisfied. No floating debt was to be placed ahead of the R.F.C. loan either as to maturity

or collateral. Since both the debenture holders and creditors received stock under the reorganization plan, there would be no conflicting interests. All concerned would work toward the company's operating at a profit.

The R.F.C. would expect each of two local banks to participate 10% in any loan it might make to the company. Although the R.F.C. would guarantee these bank loans and consequently assume responsibility for the entire amount of any loan, there were several advantages in having the banks participate. In the first place, the R.F.C. would have to advance only 80% of the loan granted. Secondly, constant check by the banks would place the company's operations under closer scrutiny. Thirdly, banking connections would be available to the company after the R.F.C. loan matured.

The R.F.C. requested a change in management and insisted that the executive committee include a representative of the R.F.C., plus a representative for each of the participating banks. The remaining four members of the committee would represent holders of the old debentures. The executive committee was to have entire control of the company's operations.

Unless the R.F.C. made an exception, no salary of over $2,400 could be paid to any officer of the company. Exception would probably be made only in the case of a few major executives.

Payment of dividends on the new preferred stock would be permissible only after the interest and the installment on the principal had been paid on the R.F.C. loan. Furthermore, the consent of the R.F.C. would be required before any disbursement of dividends on this stock.

1. What working capital policies caused the company's difficulties?

2. Should the R.F.C. have made a loan to the Hammond Manufacturing Company? Should the entire amount requested have been loaned?

3. Were the requirements prescribed by the R.F.C. sufficient to protect the loan?

4. What other conditions might have been added?

4. DOUGLAS CANNING COMPANY

BORROWING TO MEET SEASONAL NEEDS

At the suggestion of two members of the Board of Directors, the president of the Douglas Canning Company was reviewing the advantages of the following ways of supplying the company with funds for its seasonal needs in 1936: (1) borrowing from commercial banks and (2) using commercial paper.

The Douglas Canning Company packed annually from 500,000 to 750,000 cases of spinach, peas, corn, tomatoes, and tomato products purchased under contracts from local farmers. The packing season lasted usually from early May until the middle of September. Canned goods were warehoused at the plant and were sold throughout the year. The heaviest selling season occurred in the late winter. Additional funds were needed during the packing season to pay the farmers upon receipt of their products and to pay the employees of the cannery. These funds were recovered from the sale of canned goods during the winter months. Borrowings normally ran from $100,000 to $150,000 during the peak of the borrowing season. Since its organization in 1916, the company had been able to operate at a profit except in 1922, 1932, 1933, and 1934, and dividends had been paid except in those four years and in 1935.

Lines of credit had been established with two local banks and with one bank in Chicago. Relations with the banks had been satisfactory. The company had been able to pay its notes at maturity and had cleaned up its borrowings in all but two of the years of operation. In one year, 1929, the company had not found it necessary to borrow at all. In 1920 the company had obtained funds by the issuance of commercial paper through a prominent New York commercial paper house, but the present chief executive of the company had never utilized this source of credit.

One of the directors advocated the use of commercial paper because he believed that its use would not only increase the

familiarity with the company's name by the public but would also evidence the sound financial condition of the company, inasmuch as commercial paper houses were known to issue paper only for companies with exceptionally high credit ratings. Another director believed that since the transactions with commercial paper houses were of an impersonal nature it was wiser to deal only with the banks in order to keep these sources of funds open as protection against adverse conditions. The president pointed out that the costs of the various methods varied from year to year depending upon supply and demand in the money markets, the practices of the banks, and the company's own credit rating. He believed that in 1936 there was probably little difference in cost between bank borrowing and issuing commercial paper.

1. What factors should the president have considered in determining a sound policy for seasonal borrowings?
2. What were the advantages of borrowing through commercial paper rather than through banks?
3. In borrowing from banks is it essential to establish a line of credit?
4. Is it wise to have a consistent long-range policy in regard to seasonal borrowings?

5. GRANGER FLOUR MILLS COMPANY[1]

COMMODITY-SECURED LOAN TO A WHEAT MILLER

The Granger Flour Mills Company, which was located in a small middle western city, produced high-quality wheat flour. In October, 1924, Mr. George Thomas, the president of the concern, called on the Mid-Continent National Bank of Chicago to make inquiry regarding bank loans secured by stored wheat. Mr. Thomas informed the Mid-Continent National Bank that he was dissatisfied with the manner in which his company's secured loans were being handled by the local bank then having this business. He outlined the restrictions imposed upon such loans, as follows: (1) a margin of 20% at market value of the wheat at all times; (2) storage in a public elevator; (3) hedging of all purchases; (4) full insurance of wheat at all times; (5) release of wheat from storage only against cash payment; and (6) the customary 20% balance requirement while the Granger Flour Mills Company was in the bank's debt.

Mr. Thomas stated that he believed a bank would be justified in imposing these conditions on a dealer whose activities were restricted to buying and selling actual grain, and who could offer no security except this grain for his promise to pay. He felt, however, that an established business such as that of the Granger Flour Mills Company should be allowed more latitude in furnishing security for its loans. He summarized seriatim his objections to the aforesaid restrictions placed on the loans secured from his company's present banking connection, as follows:

1. As to margin, the Granger Flour Mills Company was not dependent on the wheat market for its profits. The grain purchased was used solely to manufacture flour, thereby adding to the value of the product. During the 14 years in which the company had operated, milling had yielded an average annual net profit of 3% on sales, regardless of price fluctuations on the grain exchange.

[1] Ebersole, J. F., *Bank Management*, 1st ed., McGraw-Hill Book Company, Inc., New York, 1931, pp. 135–141.

2. As to storage in a public elevator, this requirement resulted in considerable inconvenience and expense. Mr. Thomas felt it to be an undesirable reflection upon the honesty of the management of the Granger Flour Mills Company.

3. As to hedging, he stated that insurance of this kind was not necessary for all the transactions of a milling company, and that the Granger Flour Mills Company often did hedge its purchases of unpledged wheat. A large part of the company's business was done on a contract basis, contracts being drawn up at a price which would yield the Granger Flour Mills Company a fair profit on wheat purchased at current levels. On this class of transactions Mr. Thomas felt that hedging was unnecessary.

4. As to releasing wheat from storage only against cash payment, Mr. Thomas objected most violently. He felt that it was unjust to the Granger Flour Mills Company and that it worked against the desire of the bank to have the most valuable security possible for its loans. He admitted that it was impossible to identify the wheat which had been pledged to the bank after it was started in the milling process and after it had been converted into flour. He stated that the Granger Flour Mills Company might as well not borrow against wheat at all if it had to pay off these loans long before it could realize upon the finished products. He pointed out that if a bank would release wheat against trust receipts giving it a claim to a proportionate amount of flour, to be set aside for it by the borrowing company, the security for the loan would be increased by the value which was added by manufacture to each bushel of grain. To take a concrete example, wheat was selling in October, 1924, at $1.52 per bushel, and flour at $8.01 per barrel, as shown in Exhibit 1. It required four and one-half bushels of wheat to produce one barrel of flour. If, then, a bank loaned $5 against four and one-half bushels of wheat, its margin would be $1.84, or 36.8% of the loan. When this wheat became flour, however, the margin would be increased to $3.01, or 60.2% of the loan.

Mr. Thomas then described what he considered to be a more satisfactory basis for borrowing against wheat, and inquired whether the Mid-Continent National Bank would care to lend under such an arrangement. The Granger Flour Mills Company would borrow on 90-day renewable notes, each note to be for $25,000 and secured by 20,000 bushels of standard-grade, high-

Exhibit 1
Prices of Wheat and Flour, by Months, 1923 and 1924*

Month	Wheat prices (Unit: average of one price weekly in dollars per bushel; No. 2 red winter, cash, at Chicago)		Flour prices (Unit: average of one price weekly in dollars per 196-pound barrel; wheat, standard patents, f o.b. Minneapolis)	
	1923	1924	1923	1924
January	1.25	1.13	6.63	6.16
February	1 35	1.13	6 70	6 28
March	1.31	1.09	6.63	6 30
April	1.31	1.07	6.96	6.35
May	1.29	1.06	6 60	6 64
June	1.19	1.12	6.26	6.88
July	.99	1.26	6 04	7 63
August	1.02	1.32	6.06	7 54
September	1.05	1 34	6.25	7 44
October	1.10	1.52	6.20	8 01
November	1.06	1.56	6.04	8.16
December	1.08	1 77	6.10	8 90

* Source: Standard Statistics Company, *Statistical Bulletin*.

quality wheat. On this basis the bank's loans would be covered if the market price of the grain purchased by the Granger Flour Mills Company averaged $1.25 per bushel. Mr. Thomas believed this to be a fair figure. When the Granger Flour Mills Company wished to take the wheat into its mill, the bank would permit the substitution of one barrel of flour for each four and one-half bushels of grain released. Mr. Thomas pointed out that even at $6.04 per barrel, the lowest price reached in recent years, the bank would have ample coverage, since at that minimum figure the 4,444 barrels of flour substituted for each $25,000 note would be worth $26,842. The Granger Flour Mills Company would agree to keep the bank's collateral fully insured at all times, would maintain balances commensurate with its borrowings, and, Mr. Thomas intimated, would not quibble over reasonable rates of interest.

The Mid-Continent National Bank found, on investigation, that the product of the Granger Flour Mills Company had an excellent reputation in the trade, that the company met its bills

promptly, and that the management was well regarded as to both ability and honesty. The bank felt also that the company's financial statement, as shown in Exhibit 2, made a good showing.

EXHIBIT 2
GRANGER FLOUR MILLS COMPANY
Financial Statement, as of December 31, 1923

	1923
ASSETS	
Cash	$ 72,313
Notes Receivable	5,447
Accounts Receivable	108,147
Inventory: Finished	104,147
Unfinished	382,413
Current Assets	$ 672,467
Land and Building	200,000
Machinery and Equipment	307,162
Investments	70,000
Total Assets	$1,249,629
LIABILITIES	
Notes Payable—Banks	$ 225,000
Accounts Payable	1,747
Current Liabilities	$ 226,747
Reserves	92,750
Common Stock	100,000
Surplus	830,132
Total Liabilities	$1,249,629
Sales	$3,332,155
Profits	Not reported
Current Ratio	2.96–1
Net Worth—Debt	4.10–1
Net Worth—Fixed Assets	1.83–1
Merchandise—Receivables	4.28–1
Collection Period	12 days
Sales—Merchandise	6.84–1
Sales—Net Worth	3.58–1
Sales—Fixed Assets	6.57–1
Acid Test	.82–1

1. Should the Mid-Continent National Bank have agreed to Mr. Thomas's proposals concerning his company's borrowing on commodity-secured loans?

2. What do the ratios reveal about the company's financial position?

3. What is the character of the company's working capital? Can the company meet its liabilities as they fall due?

6. GENERAL MOTORS CORPORATION

FORWARD COMMITMENTS AND BUDGETS

In spite of the plan of inventory control that it had adopted in 1922 as a result of the excessive stocks that had accumulated in the preceding period of declining demand, the General Motors Corporation in 1924 again found that its production had outrun sales As a result of this situation, the corporation further extended its method of control with a view to having stocks of finished cars in the hands of dealers and distributors, as well as its own stocks, constantly in direct relation to dealers' sales to consumers

The General Motors Corporation was formed in 1908 to act as a holding company for the stock of several automobile manufacturing companies. In 1916 it was reorganized and assumed the functions of management. Each major company or division retained its own identity, however, and, until 1922, each in practice operated with complete independence, the nature of the control by the General Motors Corporation was purely advisory

In 1918 the General Motors Corporation had embarked upon a program of expansion calling for a capital expenditure of $281,556,104 At that time the corporation consisted of four passenger car manufacturing divisions—Buick, Cadillac, Oakland, and Oldsmobile—and a truck division By the end of 1920, the corporation had established, or acquired by purchase of a complete or controlling interest in other companies, plants which enabled it to manufacture all the engines and many of the materials, parts, and accessories for its automobiles Among the products were Harrison radiators, Hyatt roller bearings, Klaxon horns, New Departure ball bearings, Delco-Remy starting, lighting, and ignition systems, and Fisher bodies, many of these parts and accessories also were used by other manufacturers The General Motors Corporation in 1918 had plants in about a dozen states in the United States. Subsequently new products were added and the whole organization was further expanded

For the expansion program carried out in the three years 1918 to 1920, a total of $384,633,199 was provided, leaving after capital expenditures $103,077,095 available for working capital, which, with net working capital as of the beginning of the period, gave a total working capital under the program of $168,683,064. Twenty-seven per cent of the funds for the expansion program were provided from current operations, 38% from sale of securities, and 35% from issue of securities in payment for properties acquired.

The following material is quoted from the company's annual report for the year ended December 31, 1922:

As the net working capital requirement of today, operating under a schedule almost identical with that laid down for the year August, 1920, to August, 1921, is about $126,000,000, the net working capital available under the original program, about $168,000,000, should have been much more than sufficient for the lesser operations of the year 1921. From the above it is clear that full provision for the construction and expansion program of the years 1918 to 1920, including working capital, was made prior to the end of the year 1920. Therefore, this program was in no wise responsible for the financial difficulties under which the corporation labored during the latter part of 1920 and the year 1921. Explanation of these difficulties lies in another quarter.

At the close of the year 1920 the net working capital, exclusive of notes payable, in use prior to the write-off of inventories, was $242,830,271 or $116,354,034 above the amount required (December, 1922) to carry more than double the production of the earlier period. This made it necessary to borrow a maximum of $82,784,824 (on October 31, 1920). The reduction of the surplus materials purchased at high prices, and of inventory and other commitments made prior to December, 1920, resulted in a total liquidation loss of $84,869,893.

This condition of affairs was not reached without anticipatory warning. In the month of March, 1920, the president presented to the executive committee a schedule of proposed production made possible by the construction and expansion program then well on toward completion. He proposed that this schedule be adopted for the year August, 1920, to August, 1921. Though approved at the time, the schedule was revised in the month of May, 1920, to a proposed production almost identical with that in force during the last nine months of 1922. At this early date (May 13, 1920), the executive committee and finance committee noted the continued increase of inventories (to $167,965,641 on April 30, 1920). The chairman of the finance committee explained fully to those in charge of operations of the corporation the necessity of control, and, at his suggestion, a committee was appointed to allot among the divisions of the corporation the $150,000,000 considered available for inventories. The chairman also stated

that it was necessary not to increase inventories beyond this amount during the succeeding 12 months

The report of the inventory allotment committee was presented and approved before June 1, 1920 It was unfortunate that the rulings of the executive and finance committees and their cautions remained unheeded As a result, inventories reached a total of $209,000,000 at the end of October, 1920, exceeding by $60,000,000 the allotments of the executive and finance committees and by $100,000,000 the amount in actual use during the active summer of 1922 This excess accounted for about 70% of the borrowings at that time

It was doubly unfortunate that the spirit of the committee rulings was totally disregarded by a few of the divisions, the losses of which, due to expanded inventories and commitments for the future, amounted to $48,579,872, or much more than the total operating deficit of the whole corporation during the year 1921 The operating losses of these divisions during the liquidation and reconstruction period of 1921 added $15,330,938, making a total of $63,910,810 on their account

Though the losses above enumerated were enormous, it should be fully realized that they were not typical of the operations of the corporation as a whole, in fact, they related to 10 divisions only out of a total of 34

Under the corporation's system of inventory and purchase control installed as a result of the liquidation losses in 1920 to 1921, the executives of the various car divisions submitted to the corporation vice president who was in charge of that group of divisions, at some time before the beginning of each sales year, estimates of sales in units and in dollars, and of costs, profits, capital requirements, and return on investment for the year. These forecasts were analyzed and, upon approval of the executive committee of the corporation, of which the president acted as chairman, were accepted as divisional indexes, or general guides for the year's operations.

At the beginning of each month, each car operating division submitted to the group executive a detailed forecast of operations for the current month and the three succeeding months, covering sales and production for each month, and indicating the investment at the end of each month in inventories and other items of working capital, and also outstanding inventory commitments These forecasts were considered to be accepted unless the president, to whom the group executive referred them, communicated objections to the division executives within a week. Upon acceptance, the forecast constituted authority for the division to proceed upon the indicated manufacturing schedule and to

make forward commitments up to the requirements of the forecast Special authority from the corporation executives was required to cover any commitments beyond those requirements The approved practice of the divisions was to release immediately upon adoption of the production schedules the materials required for the following month and to make definite commitments beyond one month only for those items which required a longer period for their manufacture and delivery to the plant.

Running comparisons of the divisional forecasts with actual results embracing an eight months' period were made in the president's office each month. To stimulate the divisions to strive for accuracy in making forecasts, a general score sheet, listing the divisions in the order of the percentage of accuracy of estimates, was prepared each month in the president's office and forwarded to the divisions.

In 1924, the General Motors Corporation, like other automobile manufacturing organizations, found it necessary to liquidate excess stocks which again had accumulated In its annual report for 1924, the corporation said

> The first five months of 1923 developed an unprecedented demand for the corporation's products and an inability to meet this demand This resulted in loss of sales and some dissatisfaction on the part of the corporation's dealer organization on account of failure to make adequate delivery Production was maintained at a high rate during the year 1923 Sales during that year were the largest in the history of the corporation
>
> Anticipating a large spring demand, production was maintained at capacity, during the first quarter of 1924 During this period, a reduction in general industrial activity occurred and the spring demand did not materialize to the degree anticipated

The corporation's production of automobiles in 1924 was 26% below that in 1923 Retail sales of the dealer organization, however, were only 10% below those of 1923

After this second experience with the building up of excess stocks, the corporation decided to lay down definite requirements as to stocks of finished cars to be carried by distributors and dealers. The annual report for 1924 stated:

> This policy is predicated upon the sale of cars to consumers as a fundamental index Such sales are subject to seasonal fluctuations and the merchandising policy of the corporation requires that dealers and

distributors shall accumulate stocks during the seasons of relatively low retail deliveries in order to facilitate prompt deliveries in seasonal periods of heavy retail demand as well as to maintain manufacturing and distributing economies afforded by a reasonably level rate of production The amount of such stocks varies with the seasons of the year and is based upon a careful analysis of the trend of retail demand No dealer is required or permitted to carry stocks beyond that point A change in trend of retail demand results in production schedules being adjusted accordingly.

In connection with this policy of regulating dealers' stocks, the corporation required its various car divisions to receive from their dealers every 10 days reports as to retail deliveries, new orders taken, total orders on hand, and the number of new and used cars on hand Each 10-day period actual results as shown by these reports were compared with the current month's forecasts, and as each month's forecasts were received they were analyzed in the light of the dealers' reports On the basis of these 10-day reports current manufacturing schedules either were confirmed or were modified.

1 In general, what various forward commitments of financial significance must General Motors Corporation make annually?

2 How can such commitments affect the financial welfare of a large corporation? Might such commitments affect both working and fixed capital?

3 Discuss critically plans for control of such commitments worked out by this corporation Which one was most effective and why?

4 What are the scope and significance of a financial budget? What is its objective and what are its limitations?

7. HAWAIIAN PINEAPPLE COMPANY, LTD , CALIFORNIA PACKING CORPORATION[1]

ALTERNATIVE METHODS OF RAISING WORKING CAPITAL IN A DEPRESSION

As the depression deepened following 1929, the large canning companies found their inventories accumulating, the market price for their products falling, and the need for additional working capital becoming acute The Hawaiian Pineapple Company, Ltd , met its need for working capital by the selling, in the spring of 1931, of a new $5,000,000 issue of 5-year 5% notes The California Packing Corporation, on the other hand, met its problem by the sale, in 1930, of a $15,000,000 issue of 10-year 5% convertible gold debentures

The Hawaiian Pineapple Company, Ltd., operating some 38,000 acres of pineapple lands, was the largest factor in pineapple production in 1930, and operated what was probably the world's largest canning plant, covering some 30 acres Pineapple production, improved by careful research and experimentation, was carried on by modern large-scale farming equipment and the heavy use of fertilizer

The growth cycle was relatively long, requiring normally five or six years for completion The first two years of the cycle were usually devoted to fallowing the land for the purpose of decomposing the stumps of the exhausted plants and allowing time for the destruction of nematode and other fungus growths inimical to pineapple culture Frequently cover crops were utilized for the restoration of chemical elements in the soil The plants to be set out, obtained from pineapple tops, suckers, and slips, were first dried in the sun for several weeks, and then inserted in the ground through a layer of mulching paper which prevented the growth of weeds, conserved moisture, and insured an even temperature of the soil Approximately 18 months to 2 years after the plants were set out, the crop was ready for harvest, one pineapple being obtained from each plant. Two

[1] See Appendix I, "Analysis of Financial Statements," p 355

slips were allowed to grow on the plant, and 12 months later a second or ratoon crop, with two pineapples to each plant, was harvested If the areas still contained thriving plants, a second ratoon or third crop might be obtained at the end of an additional year Usually the plants by this time gave evidence of exhaustion and were destroyed in preparation for another cycle.

In spite of the even year-round climate of Hawaii, pineapples had an inexplicable tendency to ripen in the months of July and August, causing a tremendous peak of operations in the summer months although a sufficient number ripened throughout the year, especially around January, to make necessary harvesting and canning operations every few days, even in off-peak seasons.

Warehousing of the finished goods was carried on at the plant with a warehouse capacity in 1930 of 3,500,000 cases. The canning capacity was 80,000 cases or approximately 2,000,000 cans a day, and the high-speed canning machinery made possible a production as high as 1,684 cans per minute. During the season's peak, the company employed about 8,000 persons in the cannery, the offices, and on the plantations

The California Packing Corporation was also a large producer and canner of pineapples, pursuing in general the same methods as those employed by the Hawaiian Pineapple Company, Ltd In addition it processed an extensive line of California fruits, vegetables, and sauces, and through subsidiary and affiliated companies also packed middle western products and Alaskan and Pacific coast sea foods Many of its products other than pineapples were bought under contracts from growers It also owned a large peach and apricot orchard in Merced, California

Marketing conditions in the canned fruit and vegetable industry had long been chaotic. The Hawaiian Pineapple Company, Ltd , sold through brokers and advertised a one-price policy, while some of its competitors at times offered brokerage and other discounts to large buyers, at the same time maintaining a list price substantially conforming to the published prices of the Hawaiian Pineapple Company, Ltd. This lack of stable marketing policies did not become acute until the fall of 1930, because total supply consistently lagged behind demand, and carrying over a reasonable inventory of finished products presented no serious problems.

Seriously retarded sales in the fall of 1930, however, following the largest volume of sales in the history of the Hawaiian Pineapple

EXHIBIT 1
HAWAIIAN PINEAPPLE COMPANY, LTD
Condensed Comparative Balance Sheet, as of December 31

	1930	1931
ASSETS		
Cash	$ 984,958	$ 1,031,743
Accounts and Notes Receivable, Less Reserves	1,411,295	830,417
Inventories (at the lower of cost or market)	5,111,572	8,036,792
Growing Crops at Cost—applicable to current operations	2,637,023	2,515,814
Cash Value of Life Insurance	178,798	202,762
Total Current Assets	$10,323,646	$12,617,528
Growing Crops (at cost—not applicable to current operations)	3,264,117	2,584,184
Prepaid Expense	1,801,060	1,639,675
Land, Buildings, and Equipment, Less Reserves	9,831,605	10,899,171
Goodwill and Contracts	1	1
Treasury Stock, at Cost		99,461
Investments	275,001	260,001
Total Assets	$25,495,430	$28,100,021
LIABILITIES		
Accounts Payable	$ 827,935	$ 442,193
Due to Customers		570,147
Notes Payable	1,775,000	4,500,000
Accrued Taxes	448,324	
Total Current Liabilities	$ 3,051,259	$ 5,512,340
Five-year 5% Gold Notes, Due April 1, 1936		5,000,000
Deferred Liabilities	778,561	908,364
Capital Stock, Par $20	14,963,700	14,963,700
Earned Surplus	6,458,359	1,460,978
Capital Surplus	243,551	254,639
Total Liabilities	$25,495,430	$28,100,021

NOTE During the year 1930 the company, with other local interests, guaranteed an advance to the U S Government for Honolulu harbor improvements necessary in connection with the transportation of pineapples Under this guarantee the company has a remote contingent liability of $100,000
Condensed from company reports

Company, Ltd , in the summer of that year, gave warning of financial difficulties inherent in a situation where pineapple cultivation had been projected into the future on an optimistic basis and where inventories were mounting in a falling market Although bank lines had been sufficient to care for seasonal

EXHIBIT 2
HAWAIIAN PINEAPPLE COMPANY, LTD
Condensed Income Account, Years Ended December 31

	1930	1931
Gross sales, Less outward freight and allowances	$12,237,957	$ 7,211,367
Expenses, except as follows	8,533,466	7,726,559
Depreciation on plant and equipment	657,609	773,427
Depreciation in value of inventory		2,425,301
Contributions to employees' retirement system	142,455	130,978
Total expenses	$ 9,333,530	$11,056,265
Net profit on sales	2,904,427	3,844,898[d]
Other income	541,489	439,788
Gross income	$ 3,445,916	$ 3,405,110[d]
Interest paid and accrued, discounts allowed, etc	279,571	445,277
Employees' participation under profit sharing plan	206,243	
Net income	$ 2,960,102	$ 3,850,387[d]
Special charges, net	19,569 (*cr*)	24,725
Accrued income taxes	448,324	
Net income to surplus account	$ 2,531,347	$ 3,875,112[d]
Dividends paid—cash	1,496,158	1,122,270
stock	2,492,460	
Total dividends paid	$ 3,988,618	$ 1,122,270
Balance	1,457,271[d]	4,997,382[d]

[d] Deficit
cr Credit
Condensed from company reports

borrowings, the possible need for additional working capital through the period of stress led to the sale of a $5,000,000 issue of 5-year 5% notes in the spring of 1931 The balance sheet and income statement for the Hawaiian Pineapple Company, Ltd , for the years, 1930 and 1931, were as shown in Exhibits 1 and 2

The annual report of the company for 1931 contained the following statements

The year has been characterized by rapid change, the visibility has been extremely low, and events even two or three months ahead could not be foreseen with accuracy During 1929 and up to July, 1930, a shortage of pineapple kept us keyed up to the expectation of readily marketing our production Ideal weather conditions and improved agricultural practices cured the shortage coincident with the secondary stage of the present severe depression

This depression was at first expected by nearly everyone to be short-lived Although sales fell off, occasional spurts, together with false starts in the general situation, gave promise of an early bettering of conditions

On January 1, 1931, we had a negligible quantity of unsold goods on hand and the inventory of undelivered sales was not unwieldy As conditions became worse in the spring, however, it was evident that much of this sold pineapple might not move into consumption before the new packing season In the spring we borrowed $5,000,000 by an issue of Five-Year 5% Gold Notes to provide working capital to fortify our position

Realizing the seriousness of mounting inventories, new prices named in April, 1931, were set at a level designed to stimulate sales and move the estimated production of the year Following a big movement in May, sales during the summer were disappointing Conditions became even worse in the fall It was evident that a reduction of prices was the only course which would tend to stimulate declining sales and to move our inventory into consumption

Accordingly, we put into effect in October the lowest prices in the history of the industry, and while the final outcome of this move will be apparent only in the spring of 1932, the accelerated movement of pineapple into consumption since the price decline has been gratifying

In assuring ourselves that these prices would be passed on to the consumer it was necessary to rebate on floor stocks in the hands of our customers, as well as to absorb the loss involved in the extremely low prices

Under these conditions operations have inevitably resulted in heavy losses and depletion in surplus We are exerting every effort, however, to effect the lowest possible costs of production, looking toward the placing of our operations on a profitable basis as soon as possible

The California Packing Corporation found the decline in commodity prices and mounting inventories affecting its business just as the company completed an extensive building program including the erection of three new canning plants—one in the Middle West for vegetables, one in the Philippine Islands for pineapple, and a third in Haiti for the export business in pineapple and grapefruit It was at the same time vigorously promoting the sale of a line of coffee.

EXHIBIT 3

CALIFORNIA PACKING CORPORATION

Consolidated Balance Sheet, as of February 28

	1930†	1931
ASSETS		
Cash	$ 2,400,046	$ 3,164,621
Accounts Receivable	8,749,025	7,654,698
Notes Receivable	12,704	49,694
Advances to Growers	1,424,133	1,608,927
Materials and Supplies	4,015,430	4,517,897
Inventories	13,083,501	21,686,454
Total Current Assets	$29,684,839	$38,682,291
Deferred Charges	2,727,524	4,161,324
Land, Buildings, and Equipment, Less Reserves	19,624,556	23,251,757
Investments in Other Companies	15,155,509	
Investment in Subsidiary		8,871,385
Other Investments		227,701
Employees' Stock Subscriptions		1,359,123
Total Assets	$67,192,428	$76,553,581
LIABILITIES		
Notes Payable	$ 8,750,000	$ 8,355,389
Accounts Payable	4,363,958	3,076,624
Accrued Interest		125,000
Dividends Declared	977,416	977,416
Provision for Federal Tax	650,000	193,076
Total Current Liabilities	$14,741,374	$12,727,505
Ten-year 5% Convertible Gold Debentures, Due 1940		15,000,000
Minority Interest in Subsidiary Companies		193,505
Stated Capital*	30,000,000	30,000,000
Earned Surplus	22,451,054	18,632,571
Total Liabilities	$67,192,428	$76,553,581

* Represented by 977,416 shares of no-par-value stock (authorized 1 500,000 shares).

† In 1930 company had a contingent liability of $1,187,504 for foreign drafts discounted and letters of credit

Condensed from company reports

These conditions led the California Packing Corporation to obtain new capital through the issuance in 1930 of a $15,000,000 issue of 10-year 5% convertible gold debentures These debentures were convertible into common stock beginning October 1,

EXHIBIT 4
CALIFORNIA PACKING CORPORATION
Consolidated Income Account, as of February 28

	1930	1931
Profit from operations—after deducting all expenses and provision for Federal taxes	$5,403,685	$ 85,180
Income from investments	620,664	6,000
Total income	$6,024,349	$ 91,180
Dividends declared	3,909,664	3,909,664
Balance	$2,114,685	$3,818,484[d]

[d] Deficit
Condensed from company reports

1930, on the following basis. $70 per share to January 1, 1933, $75 through July 1, 1935, $80 through January 1, 1938, $90 thereafter to maturity. The balance sheet and income figures for the California Packing Corporation for the years, 1930 and 1931, are shown in Exhibits 3 and 4

1 In view of the nature of the pineapple industry, which company pursued the sounder method of raising working capital?

2 What other methods might have been considered?

3 What is the nature and significance of working capital and its administration?

8 ANACONDA COPPER MINING COMPANY

DEBENTURE ISSUE TO RETIRE BANK LOANS

In the summer of 1935 the Anaconda Copper Mining Company brought out a $55,000,000 issue of 4½% sinking fund debentures to pay off notes of the company and its subsidiaries held by the Guaranty Trust Company, The National City Bank, and The Chase National Bank of New York.

EXHIBIT 1
PRINCIPAL USES OF COPPER IN THE UNITED STATES IN 1934

	Short tons	Per cent
Electrical manufactures	101,000	21 72
Telephone, telegraph, and radio sets	30,600	6 58
Light and power lines and other wire	80,000	17 20
Automobile manufacture	63,000	13 56
Buildings	36,000	7 74
Refrigerators	16,200	3 48
Other	138,200	29 72
Totals	465,000	100 00

Source American Bureau of Metal Statistics, Moody's *Industrials*

The company was incorporated in 1895 under the laws of Montana as Anaconda Copper Mining Company. Since that time the company and its subsidiaries had become the largest producers and fabricators of copper in the world, mining, smelting, refining, manufacturing, and distributing not only copper but also lead, zinc, and other non-ferrous and precious metals. In addition extensive operations had been conducted in lumber, coal, and oil The uses for copper and the principal producing countries are given in Exhibits 1 and 2 The volume of copper produced in the United States and the prices obtained are shown in Exhibit 3.

The output of the company's refineries and the capacity of its fabricating plants had been about equal, but these facilities had exceeded the production of the company's domestic mines. In recent years, however, extensive copper reserves had been acquired

EXHIBIT 2
PRODUCTION OF COPPER IN PRINCIPAL PRODUCING COUNTRIES
Smelter Production of Blister Copper
(In thousands of tons of 2,000 pounds)

	1931	1932	1933	1934
United States	525	256	234	232
Chile and Peru	299	137	208	313
Canada	146	125	148	183
Europe	158	165	189	200
Africa	169	155	200	293
Japan, Mexico, and others	192	150	158	161
Total World	1,489	988	1,137	1,382

Source American Bureau of Metal Statistics, Moody's *Industrials*

EXHIBIT 3
PRODUCTION OF COPPER IN THE UNITED STATES AND AVERAGE PRICE OF ELECTROLYTIC COPPER IN NEW YORK

	1925	1926	1927	1928	1929
Tons*	837	870	842	913	1,001
Price†	14 08	13 79	12 92	14 57	18 11

	1930	1931	1932	1933	1934
Tons*	697	521	272	225	238
Price†	12 98	8 12	5 56	7 02	8 43

* Smelter production, from domestic ores, in thousands of tons of 2,000 lbs Source U S Bureau of Mines, Moody's *Industrials*
† Average price of electrolytic copper in New York in cents per pound Source *Engineering and Mining Journal*, Moody's *Industrials*

in Mexico and Chile. The prospectus accompanying the new debentures noted:

An import tax of 4 cents per pound on copper imported into the United States became effective in June, 1932, for a period of three years Such tax was extended for a period of two years by an Act passed at the recent session of Congress Prior to the imposition of the 4-cent tax it was the practice to market in the United States a part of the copper output of the Company's subsidiaries located in Chile and Mexico The production of the Company's subsidiaries in Chile and Mexico since the imposition of the tariff has been sold abroad, either as metals or fabricated products

EXHIBIT 4
RATES ON BANK LOANS AND CORPORATE BOND YIELDS

	Rates charged customers by banks in New York City (weighted averages of prevailing rates)		Corporate bond yields (Moody's ratings)			
			Aaa 30 issues		Baa 30 issues	
	1934	1935	1934	1935	1934	1935
January	3 58%	2 83%	4 35%	3 78%	7 01%	5 99%
February	3 43	2 90	4 20	3 72	6 27	5 97
March.	3 31	2 64	4 13	3 71	6 26	6 22
April.	3 39	2 61	4 07	3 72	6 01	6 14
May	3 42	2 69	4 01	3 74	6 05	5 99
June	3 30	2 66	3 93	3 72	6 06	5 86
July	3 30	2 61	3 89	3 70	6 13	5 77
August	3 33	2 67	3 93	3 77	6 49	5 69
September	3 26	2 72	3 96	3 80	6 57	5 62
October	3 28	2 72	3 90	3 79	6 40	5 63
November	3 22		3 86		6 37	
December	3 18		3 81		6 23	

Rates on Industrial Advances approved by Federal Reserve Board under Sec 13*b* of Federal Reserve Act as amended June 19, 1934 were New York, 4–6 %, Minneapolis, 6 %
Source *Federal Reserve Bulletins*

EXHIBIT 5
ANACONDA COPPER MINING COMPANY
Brief Description of 4½% Debentures

Dated —October 1, 1935, due October 1, 1950
Authorized and Issued —$55,000,000
Redeemable —The debentures are redeemable at any time prior to maturity as a whole or in part on 30 days' notice Redemption price (as a whole) is 105 prior to October 1, 1940, 104 to October 1, 1945, 103 to October 1, 1946, and thereafter ½ less each year to October 1, 1949, and at 101 from that date to maturity

Security —A direct obligation of the company but not secured by a mortgage Indenture provides that company will not, except as expressly permitted, at any time directly or indirectly mortgage or pledge any of its property or assets now owned or hereafter acquired without equally and ratably securing these debentures therewith

Sinking Fund —Provision was made for payment on August 15 of each year, to and including August 15, 1949, of an amount equal to $1,000,000 plus 20% of the consolidated net income for the preceding year ended December 31 The agreement set a maximum amount for the sinking fund payment, however In lieu of making payments in cash, the company might deliver debentures to the trustee, each such debenture to be received by the trustee in lieu of cash in an amount equal to purchase price of such debenture paid by the company

Dividend Restrictions —Company covenanted that it would not declare a cash dividend on any of its capital stock if before or after the declaration of such dividend the consolidated net assets would be less than (*a*) $50,000,000, or (*b*) 1½ times the aggregate principal amount of debentures outstanding, whichever was less

Condensed from *Standard Corporation Records*

In 1935 when Anaconda Copper Mining Company was bringing out the new debenture issue, rates charged to customers by banks in principal cities were lower than at any other time in the entire postwar period, according to the Federal Reserve Board Rates varied between certain large loans at 1% and 2% and smaller, less secure loans at 5% and 6% Serial notes to banks at very low rates were being used by some corporations to retire bonds and preferred stocks Rates current in this period are shown in Exhibit 4

Plans for the sale of the debentures as indicated by the prospectus were as follows the issue would be offered to the public at 98½% of face value plus accrued interest to date of delivery A selling group to be formed by the underwriters was to be offered debentures at the public offering price less a discount of 1½% of the principal amount, while the underwriters were to receive discounts or commissions of 3% of the principal amount of the debentures from the public offering price Additional information regarding the proposed issue is given in Exhibit 5 Exhibits 6 and 7 present condensed balance sheets and operating statements for the Anaconda Copper Mining Company

1 What possibilities other than the debenture issue were open to the company in retiring its bank loans?

2 What were the dangers and what were the advantages of issuing debentures?

3 Why did this company propose to switch from bank loans to debentures when other companies were refinancing bond issues by borrowing from banks?

EXHIBIT 6

ANACONDA COPPER MINING COMPANY AND SUBSIDIARY COMPANIES

Consolidated Balance Sheet, December 31, 1927–1934

(In millions of dollars)

	1927	1928	1929	1930	1931	1932	1933	1934
ASSETS								
Cash	$ 10.8	$ 23.3	$ 16.2	$ 12.2	$ 6.4	$ 6.1	$ 6.6	$ 12.2
Marketable Securities	7.2	2.5	17.2	15.4	2.7	2.5	2.7	1.5
Accounts Receivable	16.2	20.2	26.1	15.5	11.1	7.3	9.2	5.9
Inventories	53.3	55.7	84.7	68.0	64.8	47.5	44.2	35.9
Notes Receivable						4.5	5.9	6.9
Mines and Lands	136.5	101.4	295.0	295.4	297.8	297.7	298.7	296.8
Buildings and Machinery	172.8	133.6	255.9	262.6	264.7	264.1	264.2	265.7
Investments	98.1	144.4	25.3	26.3	26.4	27.5	27.5	29.0
Other Assets	33.2	24.6	43.8	43.7	40.2	36.9	33.4	30.6
Total Assets	$528.1	$505.7	$764.2	$739.1	$714.1	$694.1	$692.4	$684.5
LIABILITIES								
Notes Payable	$ 12.0	$ 13.0	$ 35.0	$ 47.5	$ 61.5	$ 70.5	$ 69.9	$ 59.5
Accounts Payable and Accruals	15.7	16.3	27.2	17.0	9.8	9.2	7.7	8.1
Dividends Payable	2.2	5.5	15.5	5.5				
Funded Debt	213.9	136.7	37.2	37.1	37.0	35.3	32.6	29.4
Reserve for Depreciation	46.4	50.2	83.7	90.6	95.1	97.0	103.3	108.6
Minority Interest in Subsidiaries	1.9	1.9	12.2	7.9	5.2	4.7	4.6	4.6
Other Liabilities				2.7	2.1	1.7	2.6	3.3
Capital Stock	150.0	182.4	441.4	443.3	433.8	433.6	433.7	433.7
Surplus	86.0	99.7	112.0	87.5	69.6	42.1	38.0	37.3
Total Liabilities	$528.1	$505.7	$764.2	$739.1	$714.1	$694.1	$692.4	$684.5

Source Company reports

EXHIBIT 7

ANACONDA COPPER MINING COMPANY AND SUBSIDIARY COMPANIES

Consolidated Income Statement, Years Ended December 31, 1927–1934

(In millions of dollars)

	1927	1928	1929	1930	1931	1932	1933	1934
Gross revenue	$200.5	$237.9	$305.8	$179.3	$96.4	$52.3	$72.9	$99.2
Cost of sales and taxes	179.2	211.8	224.0	150.9	90.0	59.9	70.8	87.4
Operating income	$ 21.3	$ 26.1	$ 81.8	$ 28.4	$ 6.4	$ 7.6[d]	$ 2.1	$11.8
Other income	7.0	13.7	8.5	2.7	.8	.6	2.0	1.2
Total income	$ 28.3	$ 39.8	$ 90.3	$ 31.1	$ 7.2	$ 7.0[d]	$ 4.1	$13.0
Depreciation	4.8	5.3	11.7	8.2	5.9	4.3	5.2	6.3
Interest	13.4	10.3	8.3	4.1	4.5	5.6	5.7	4.8
Minority interest			1.2	.4				
Net income	$ 10.1	$ 24.2	$ 69.1	$ 18.4	$ 3.2[d]	$16.9[d]	$ 6.8[d]	$ 1.9
Earned per share	$ 3.37	$ 6.63	$ 7.83	$ 2.07	$ 0.37[d]	$ 1.94[d]	$ 0.79[d]	$ 0.22
Number of shares outstanding	3,000,000	3,648,311	8,828,063	8,866,380	8,676,916	8,672,670	8,673,833	8,674,342
Price range—common stock	41¼–60½	53¾–120¼	67¼–174⅞	25–81½	9¼–43¼	3–19⅜	5–22⅞	10–17¾

[d] Deficit

Sources: Company reports, Moody's *Industrials*

9 WILSON LUMBER COMPANY

EXTENSION OF TRADE CREDIT TO A COMPANY IN REORGANIZATION

In April, 1935, the Hammond Manufacturing Company[1] prepared a plan of reorganization under Section 77B[2] of the National Bankruptcy Act, to terminate the receivership that had begun a year previously Among the general creditors was the Wilson Lumber Company, which had been owed $43,500 since before the receivership Directors of the Wilson Lumber Company had to decide whether or not to accept the proposed reorganization plan and to determine their company's future credit policy with the Hammond Manufacturing Company

John L Hammond began manufacturing high-quality furniture in 1879 He was very successful and accumulated large individual resources In 1906, the business was incorporated in Michigan, and 100,000 shares of common stock were issued The Hammond family continued to manage the company until the appointment of receivers in 1934 The company had always enjoyed a favorable reputation for the style and quality of its furniture Its goods were sold nationally to the better retail outlets The company maintained a large plant in a middle western city where it was employing 1,176 persons in 1934.

The substantial increase in production facilities which the company planned in 1926 was financed partly out of earnings and partly by a $4,500,000 issue of 5% debentures which were sold in 1927 The circular for this bond issue stated that average net earnings for the previous five years were seven times the annual interest requirement on the proposed bond issue Total net assets were on August 31, 1927, $9,350,678, which amounted to over $2,000 in assets for every $1,000 in debentures The current ratio at that time exceeded eight to one, monthly bills constituted the only debt

In 1930 the depression began to make serious inroads on the company's sales volume Consumers had stopped buying or were

[1] Further description of this company is given in the case of the Hammond Manufacturing Company, p 107

[2] For a brief explanation of Section 77B, see p 272

turning away from high-price furniture. This trend continued at an accelerated rate The company failed to reduce costs substantially, and large losses were incurred Sales and income for the years 1929 through 1934 were as follows

(In thousands of dollars)

	1929	1930	1931	1932	1933	1934
Net Sales	$8,462	$6,155	$3,422	$1,283	$1,964	$3,472
Net Profit	411	1,358[d]	2,042[d]	2,049[d]	527[d]	553[d]

[d] Deficit

Selected balance sheets are presented in Exhibit 1.

EXHIBIT 1
HAMMOND MANUFACTURING COMPANY
Balance Sheet

	As of Aug 31, 1933	As of Dec 1, 1934	Pro forma after R F C loan
ASSETS			
Cash	$ 73,416	$ 23,696	
Securities	361,416		
Trade Receivables	578,738	77,940	
Inventory	1,351,671	1,239,726	
Total Current Assets	$2,365,241	$1,341,362	$1,632,926
Fixed Assets	5,234,502	4,650,318	4,650,318
Other Assets	25,443	503,685	503,685
Patents	1		
Deferred	14,004		
Total Assets	$7,639,191	$6,495,365	$6,786,929
LIABILITIES			
Notes Payable	$ 750,000		
Accounts Payable	103,796	$ 280,621	
Accrued Items	155,143	272,543	
Total Current Liabilities	$1,008,939	$ 553,164	none
Reserves	71,841		
10-year 5% Debentures, Due 1937	2,606,250	2,640,276	
R F C Loan			$ 750,000
Capital—100,000 Shares No-par Common	3,952,161	3,301,925	6,036,929*
Total Liabilities	$7,639,191	$6,495,365	$6,786,929

* Includes 400,000 shares of $10-par preferred stock

Sinking fund requirements of $200,000 annually on the principal amount of the debentures became increasingly oppressive, and payments for some time were made from current assets which were needed in the business, and from bank borrowings. Working capital was reduced further when the banking disorders of 1932 and 1933 forced this company's banks to demand repayment of their loans. Moreover, the company found it impossible to secure prompt payment from its customers. The slow collection of receivables and a lack of cash forced the company to request longer terms from its own merchandise creditors

In December, 1933, the company defaulted on its sinking fund payment, and a minority of bondholders refused to waive this requirement. In trouble with bondholders and short of cash, the company was forced into receivership in March, 1934 At that time the company was reported to have a current ratio of three to one, although it was unable to pay merchandise bills of approximately $100,000

Receivers were appointed to replace the former management, which had been criticized by various parties. It was felt that the lack of a low-price line to supplement the company's high-price line of furniture had placed it in a weak position to meet the trend to lower-price products. Costs had not been reduced proportionately as sales volume decreased. Furthermore, the company had been criticized in August, 1933, for not making public adequate financial information concerning its operations

During the year 1934, the stock-turn was 1 77, only 30% of the usual figure. Current financing was carried on by discounting current receivables with an individual interested in the company Trade bills incurred by the receivers were paid satisfactorily.

In April, 1935, the company proposed to reorganize under Section 77B of the National Bankruptcy Act At that time the obligations of the Hammond Manufacturing Company were as follows

OBLIGATIONS INCURRED BEFORE RECEIVERSHIP

1	10-year 5% sinking fund gold debentures, due December 1, 1937	$2,606,250 00
2	Interest on same from December 1, 1933, to May 1, 1935	184,609 38
3	Interest on coupons (June and December, 1934) to May 1, 1935, at 6%	5,212 50
4	Merchandise creditors prior to state receivership	99,222 75
5	Interest on same from March 1, 1934, to May 1, 1935, at 6%	6,945 59
6	Two lessors' claims for rent in dispute	3,190 88
7	Interest on same from March 1, 1934, to May 1, 1935, at 6%	223 35
8	Taxes due, with interest	262,500 00

OBLIGATIONS INCURRED AFTER RECEIVERSHIP

1 Various claims of merchandise creditors, employees for labor, commissions due selling agents and other obligations incurred by trustees because said trustees are carrying on the business of the debtor	*
2 Services of State Receivers, Federal Court Trustees, attorneys for debenture holders committee, attorneys for debtor, Special Master, the depository, and all expenses of administration	*

* The amount of these claims was not given because they were being met currently Total accounts payable are shown on the balance sheet, however

The proposed reorganization plan contained the following proposals which affected the Wilson company.

The creation of 300,000 Preferred Certificates 5% non-cumulative, redeemable at the par value of $10 a certificate Exchange said certificates at par, and in payment of the $2,606,250 debentures, together with interest to May 1, 1935, and the claims of unsecured creditors together with interest to May 1, 1935

The Preferred Certificates shall be preferred as to assets and dividends over the present outstanding certificates, which shall hereafter be known as Common Certificates

Dividends may be declared subject to the following conditions:

1 In the event there is no existing default in the Reconstruction Finance Corporation Loan, either as to principal or interest payments

2 The dividend is earned and the capital not impaired by the declaration of the dividend

3 Consent of the Reconstruction Finance Corporation so long as any part of its loan is unpaid

Dividends may be declared in excess of 5% annually on the Preferred Certificates if the three conditions above enumerated have been complied with, but such dividends shall be applied to and credited pro rata against the face value of said Preferred Certificates in partial or total liquidation thereof

Dividends on the Preferred Certificates may be paid if earned and declared but only with the consent of the Reconstruction Finance Corporation so long as the loan by the Reconstruction Finance Corporation, or any part thereof, is unpaid

The plan further provided that

all priority claims such as taxes, expenses of administration, debts incurred by the State Receivers or Federal Court Trustees . . shall be paid in full in cash, or assumed by the reorganized Hammond Manufacturing Company, either by note or the recognition of the account payable if and when assented to by the creditor extending such credit.

Under the provisions of Section 77B, a plan of reorganization which has been accepted by the holders of two-thirds in amount of any class or classes of creditors and by the holders of a majority in amount of any class or classes of stockholders, and which, after hearing upon due notice, has been confirmed by the Court, would be binding upon all the creditors and stockholders of such class or classes, all of whom would be required to accept new securities as provided in such plan of reorganization

New working capital would be acquired primarily from an R F C loan of $750,000, maturing in five years Of this amount, $600,000 would be secured by fixed assets and $150,000 by accounts receivable and inventories Participation of 10% each would be requested of the company's two banks These bank loans would carry the R F C guarantee of repayment Furthermore, the R F C required that certain individuals interested in the company be prepared to lend $375,000, if it were needed. Sums borrowed from these individuals would be secured by accounts receivable and inventories

Control would be vested in an Executive Committee composed of four representatives of the debenture holders, one representative of each of the participating banks, and a representative of the R F C The last organization regarded the change in management as significant

From the standpoint of the Wilson company, the increase in working capital should aid the successful operation of the company and facilitate payment for new merchandise Without new capital which the Hammond company hoped to secure through reorganization, only great leniency on the part of the merchandise creditors would prevent liquidation of the company On the other hand, the trade creditors would receive nothing if further financial troubles were encountered, because all the company's assets would be pledged as security for the loans. There was no assurance that the new management could operate the business at a profit

1. What position should have been taken by the Wilson Lumber Company regarding the proposed plan of reorganization?

2 If the reorganization were completed as proposed, should the Wilson Lumber Company continue selling to the Hammond Manufacturing Company?

10. MOUNTAIN MILLS, INC.

USE OF WORKING CAPITAL

In January, 1936, the president of Mountain Mills, Inc , was faced with the problem of whether or not to loan $50,000 to Blue Hills, South Carolina, the town in which his plant was located

Mountain Mills, Inc , which was one of the larger mills in that section of the state, manufactured grey goods and sheetings Since 1926, when the company moved to the South from New England, it had had numerous dealings with the authorities of the town The cost of moving and the acute depression which the cotton-textile industry experienced during the 1920's had placed the company in a poor financial condition, by 1927 it was heavily in debt to one local and two city banks.

The president of Mountain Mills, Inc., had followed a careful policy in his relationships with the banks, and had been able to hold their confidence He was slowly paying off the bank loans which had been incurred in 1926, 1927, and 1928. Until 1933 he had invested the company's excess cash in government bonds, bankers' acceptances, and other gilt-edge short-term paper In 1932, however, the banks became so concerned over their own affairs that they insisted that all excess cash be kept on deposit with them as long as loans were due to the bank From time to time the banks urged the president to pay off the notes rather than maintain such a strong working capital position. The president had constantly stressed the company's seasonal need for capital and the fact that any sudden increase in sales would require a substantial amount of working capital

At the time when the town requested the loan, Mountain Mills, Inc , owed the banks $1,500,000 in 3-year notes which would mature in September, 1936 Interest on these loans was at the rate of 5% to 7%. The president of the company planned to retire a portion of these notes and to renew the balance, as he had been doing for a number of years He felt that by September, 1936, a payment of $300,000 could be made without surrendering

too much working capital The company's current position, as of December 31, 1935, was described briefly as follows

Current assets		Current liabilities	
Cash	$1,100,000	Accounts payable	$ 119,000
Receivables	1,200,000	Notes payable	1,900,000
Inventory	825,000	Accruals	106,000
Total	$3,125,000	Total	$2,125,000

In addition to the bank loans, notes payable included a loan from certain stockholders of $400,000 which would fall due in October, 1936.

When the company had moved south, the town of Blue Hills had treated it very fairly For the first five years the company had been tax exempt, and for the last five years the company paid only $8,000 annually in taxes The president believed that the rate was very low, in fact, he stated on several occasions that he could not have complained about heavy taxation if he had been charged from $25,000 to $30,000 annually The taxes for 1936 were paid but the question of future taxation was to come up in 1937.

The treasurer of the town of Blue Hills approached the president of Mountain Mills, Inc , for a loan because the town needed $50,000 to enable it to meet certain notes which would fall due in February, 1936. The lack of adequate funds in the town's treasury was due to the fact that one of the other large manufacturing companies had not paid its taxes The company had refused to pay them when it had learned of the low assessment placed on Mountain Mills, Inc.

1 Was the request by the treasurer of Blue Hills a reasonable one?

2 What should the president's decision have been?

3 Should a loan of this kind to the town have affected adversely the relations of the company with its banks?

11 THE KROGER GROCERY AND BAKING COMPANY

TAXES AND WORKING CAPITAL

Since the depression the annual reports of many corporations have given to stockholders and to the public far more detailed information concerning their expenses, financial condition, and operating problems than in previous years An example of this recent trend in reports is furnished by those of The Kroger Grocery and Baking Company One of the groups of problems faced by the company, as stressed particularly in the 1934 and the 1935 reports, is that of taxes and the effect on the company's earnings Exhibits 1 and 2 show the company's balance sheets and operating statements for 1934 and 1935 The following excerpts are taken from these annual reports

[ANNUAL REPORT 1934]

The tax burden placed on our company has continued to increase during the year, thus necessarily increasing the price of merchandise and throwing a large added load on the consumer, with resulting decrease in buying capacity

Since the last report, 3% sales tax laws have been enacted in the States of Kentucky and Ohio At the present time there are various forms of sales taxes in the following states in which the Kroger Company operates Illinois, Indiana, Iowa, Kentucky, Michigan, Mississippi, Missouri, North Carolina, Ohio, Oklahoma, Pennsylvania and West Virginia

There is no uniformity in sales tax laws They are all experiments and each state in which we operate has adopted a different method In theory the tax is collected by the merchant from the customer for and on behalf of the State Unfortunately in most cases this theory does not work in practice

Discriminatory chain store taxes are now in force in the states of Indiana, Wisconsin, Michigan, Kentucky, North Carolina, Minnesota and West Virginia, and in the city of St Louis, Mo , which still further add to the expense of operations and thus increase the tax burden ultimately thrown on the consumer Efforts are now being made to pass similar discriminatory taxes in many other states But this class of legislation is promoted by and for the benefit of particular groups We feel that, increasingly, legislators are realizing the benefits of the

chain store method of merchandising and are resisting the demands of small pressure groups

Here is a graphic illustration of how taxes are piled on taxes. It is fairly illustrative of the increasing burden industry is compelled to shoulder Your company operates five dairies or pasteurizing plants Taxes in many instances are laid on the operations of such dairy plants under the following headings

Income Taxes
Franchise Taxes
Real Estate Tax
Personal Property Tax
Cream Station Property Tax
Wholesale Dealers License Tax
Cream Station License Tax
Petroleum Dealers License Tax
Butter Manufacturers License Tax
Ice Cream Manufacturers License Tax
Milk Plant License Tax
Cream Testers License Tax
Retail Sales Tax
Chain Store Taxes
Weighers and Samplers License Tax
Vehicles Mileage Tax
Auto License Tax
Gasoline Tax
Auto Parts Tax
Motor Oil Tax
Tires and Tubes Tax
Telephone Service Tax
Telegraph Service Tax
Capital Stock Tax
New Cars and Trucks Excise Tax
Stock Transfer Excise Tax
Sales License Tax
Processing Taxes
Unemployment Insurance Tax

[ANNUAL REPORT 1935]

There have been enclosed with your dividend checks on two occasions during the year striking statements illustrating the extent to which the burden of taxation has increased There are indications that taxes will increase in 1936 Taxes for 1934, direct and indirect, paid by or through your company, are estimated as equivalent to approximately $10 a share or 8 5% of sales or 39% of invested capital Similar taxes for 1935 are estimated, with reasonable accuracy, as

having been equivalent to $12 a share or 10% of sales or 45% of invested capital

Under one item of the Social Security tax program alone, the Unemployment Insurance provision, effective January 1, 1936, at the rate of 1% of our pay roll, our taxes will increase approximately $330,000, or eighteen cents per share Old Age Pension taxes, effective January 1, 1937, at 1% of the pay roll plus the increase of an additional 1% in 1937 in the Unemployment Insurance tax rate, will increase our taxes in 1937 approximately $990,000, or fifty-four cents a share over 1935 Taxes under the Social Security Act increase progressively until 1949

At the date of this report, only one of the states in which we operate, Wisconsin, had enacted laws covering unemployment or old age pensions Hence, we do not know the exact cost to us of these taxes.

Your company, however, is charging against current operations an amount equal to 1% of pay roll, which is the amount for 1936 payable under the Federal Social Security Act

1 How do high taxes affect the working capital of this company?

2 Do consumers or stockholders of the company, or both, pay these taxes?

3 Why is the tax trend upward? Is it justifiable?

4 What action can a company take to meet the mounting tax bill?

5 What will be the ultimate effect on corporate securities of rising taxes?

EXHIBIT 1

THE KROGER GROCERY & BAKING COMPANY

Consolidated Balance Sheet

	Dec 29, 1934	Dec 28, 1935
ASSETS		
Cash	$ 7,951,226	$10,158,664
Federal and Local Government Securities at Par	1,140,575	679,000
Receivables, Less Reserves	1,969,973	1,819,463
Inventories, Lower of Cost or Market	20,916,910	20,129,097
Other Current Assets	744,275	661,432
Current Assets	$32,722,959	$33,447,656
Investments, Ledger Values	6,152,935	6,252,510
Other Assets	1,245,549	1,101,916
Fixed Assets	28,614,092	29,473,017
Less Allowance for Depreciation and Obsolescence	13,040,694	13,803,525
Net Fixed Assets	$15,573,398	$15,669,492
Total Assets	$55,694,841	$56,471,574
LIABILITIES		
Accounts Payable and Accruals	$ 6,459,554	$ 5,834,111
Provision for Federal Taxes	1,061,211	1,062,936
Current Liabilities	$ 7,520,765	$ 6,897,047
Other Liabilities	472,876	520,403
Capital Stock		
1st Preferred, 6% Par $100	55,800	55,700
2nd Preferred, 7% Par $100	55,200	48,400
	$ 111,000	$ 104,100
Common, Without Par,* Outstanding	33,398,276	33,398,250
Capital Surplus	883,084	1,047,761
Earned Surplus	13,308,840	14,504,013
Total Liabilities	$55,694,841	$56,471,574
* Number of shares outstanding	1,830,886 9/20	1,830,885

Condensed from company reports

EXHIBIT 2
THE KROGER GROCERY & BAKING COMPANY
Consolidated Income Account

	Fiscal period ended Dec 29, 1934	Fiscal period ended Dec 28, 1935
Net sales	$221,175,331	$229,907,884
Cost of sales	172,909,675	182,576,691
	$ 48,265,656	$ 47,331,193
Operating expenses, excluding depreciation	$ 39,620,701	$ 39,380,554
Administrative expenses	2,062,543	2,081,788
	$ 41,683,244	$ 41,462,342
Profit from operations, before depreciation	$ 6,582,412	$ 5,868,851
Allowance for depreciation	2,356,200	2,290,653
	$ 4,226,212	$ 3,578,198
Net interest earned	95,121	41,938
Profit from operations	$ 4,321,333	$ 3,620,136
Net accrued earnings from subsidiaries and affiliates	465,019	500,512
Profit before unusual income and income taxes	$ 4,786,353	$ 4,120,648
Chain store taxes recovered		467,451
	$ 4,786,353	$ 4,588,099
Federal income taxes, estimated	588,111	477 173
Net income	$ 4,198,242	$ 4,110,926

Condensed from company reports

SUMMARY QUESTIONS

1 What should the objectives be in the management of a company's working capital?

2 What are the most significant financial ratios? What is the limit of their usefulness? What additional information is required for sound analysis of working capital position?

3 What should the relationship be between the financial officers of a corporation and the sources of working capital? Illustrate

4 What is the justification of the Reconstruction Finance Corporation?

5 Discuss the difference between so-called "working capital" and "fixed capital"

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V

MANAGEMENT OF A CORPORATION'S CAPITALIZATION[1]

We have defined capital as the total resources of a business Unfortunately, in business parlance the term "capital" is ambiguously used both to indicate resources or assets and also to refer to that part of the total fund contributed by the owners Sometimes it is also used to mean both capital stock and bonded debt To this latter concept we apply the term "capitalization" or "capital structure" as distinct from capital

The wise administration of a business involves making sound decisions on all problems which concern the company's capitalization Under the heading of capitalization fall such problems as determining whether to issue par or no-par stock, adjusting the proportions between stocks and bonds, simplifying capital structure, deciding upon the type and amount of dividends to be issued, choosing plans for refinancing; judging the advantages of retiring all or part of certain stock issues, and determining whether or not to issue convertible bonds The Cleveland Tractor Company case on page 203 reveals the variety and number of these problems arising over a period of years in a rapidly expanding corporation

Although reaching wise decisions is frequently made difficult by the temptation to secure larger immediate profits, the exercise of foresight is important On these decisions depends the company's ability to withstand economic strains

The United States Steel Corporation, for example, called its bonds and issued common stock in 1929 at a time of peak earnings The main problem in that case was whether to refund the obligations at a lower interest rate or to increase the number of shares of common stock. The former course of action would have increased

[1] "The corporate estate is commercially represented by securities outstanding It is the aggregate of this paper certification of value taken at par, which constitutes capitalization" William Z Ripley, *Railroads—Finance and Organization*, Longmans, Green and Co, New York, 1920, p 55

the earnings per share on the outstanding stock and made possible the payment of larger dividends

After extended study and deliberation, the directors decided to retire or provide for the retirement of the company's $134,830,000 issue of 50-year 5% gold bonds due in 1951 and its $136,632,000 issue of 10-year to 60-year 5% bonds due in 1963. They planned to supply the required cash in part from cash resources on hand, and in part from the proceeds of selling additional shares of common stock to their common stockholders Of the 50-year 5% gold bonds outstanding, $58,368,000 were of a noncallable series. The greater part of these were held by a few interests who agreed to turn in their bonds for redemption at the call price for the callable series

The plan as outlined was carried out in its entirety. The stockholders of the corporation at the annual meeting on April 15, 1929, took the necessary action permitting the issuance and sale of the required number of shares of additional common stock. The directors' handling of the bonded indebtedness of the United States Steel Corporation was wise in view of the industry's well-known reputation as a prince and pauper industry, and especially in view of the unprecedented conditions which followed in the 1930's

Care in formulating policies affecting capitalization is also called for by a company's relations with the public. Because of the wide latitude afforded by state corporation laws, corporations may legally adopt certain policies which meet violent public criticism. The issuance of two classes of common stock, for example where only the smaller issue carries voting rights, may be supported logically. As a sound policy for corporations as a whole, however, it is open to criticism.

Officers and directors who deal with the problems of the capitalization or capital structure of a corporation must recognize their responsibilities both to stockholders and to bondholders, and they must not only understand the financial principles involved but also consider the public's reaction to and demand for securities Most executives in their management of these problems frequently turn to investment bankers, commercial bankers, and lawyers for advice and counsel in working out guiding policies

1 COMMERCIAL CREDIT COMPANY (I)

SIMPLIFICATION OF CAPITAL STRUCTURE

At the regular meeting in February, 1935, the directors of the Commercial Credit Company discussed the possibilities of simplifying the company's capital structure At that time it was decided to amend the company's certificate of incorporation so as to permit the issuance of a convertible preferred stock in place of the several kinds of preferred stock then outstanding

The following quotation from the foreword of the annual report for 1934 describes the company's business·

Commercial Credit Company, a Delaware Corporation, is a pioneer in its line, having been organized in June, 1912, with $300,000 cash capital, which has been increased several times, until today it is one of the three largest companies of its kind in the world It has never had an unprofitable year on its operations in the United States and Canada

During its existence of 23 years, the Company and its subsidiaries from dates of their acquisition, have paid to stockholders $31,177,599 in cash dividends on various issues of capital stock and also several dividends payable in Common Stock [See Exhibits 1, 2, and 3] Regular quarterly dividends have always been paid on all Preferred issues Dividends for the first and second quarters of 1933 on the Class A Convertible Stock were postponed and paid during the third and fourth quarters of 1933 During the past 22 years, 1933 was the only year in which a cash dividend was not paid on the Common Stock

The business of the Company is financing the distribution of merchandise from producer to consumer through the purchase of current self-liquidating receivables from mills, manufacturers, wholesalers, distributors, and dealers . The Company does not purchase, rediscount, or make loans, based upon real estate, so-called "character" loans, securities or miscellaneous assets, and makes very few loans upon unsold merchandise, except as is the custom in the "factoring"[1] business.

Obligations are purchased covering unpaid balances due by buyers of a wide variety of articles . . . at wholesale and also at retail, largely upon the installment plan, upon which satisfactory down payments

[1] A description of factoring is given in the case of the Parisian Silk Company, p 330

have been made and liens generally retained and/or a margin withheld, and usually further protected, where advisable, by full or limited guarantee or repurchase agreement of the seller, and by insurance

Current open accounts, notes and acceptances owing to manufacturers and wholesalers by their customers are purchased without notice of the sale to their customers About 80%, less charges, is paid at time of purchase, and the balance withheld until the Company receives payment for the receivables which are collected by the seller, who usually guarantees full payment thereof

With few exceptions, the outstanding installment receivables . generally average less than $300, and are owing by several hundred thousand diversified purchasers of a large number of articles, such purchasers being very widely distributed geographically and as to occupation

The Company enjoys exclusive contracts with several leading manufacturers in various lines, cooperating actively with them in furthering the distribution of their products through the purchase of the obligations of their distiibutors and dealers and of the latter's consumer customers The Company also does a very large business with many distributors and dealers covering the sale of various articles where it does not have such exclusive contracts with the manufacturers thereof

The company and its subsidiaries operated 141 local offices throughout the United States and Canada, and employed over 1,800 persons in December, 1934 The 1934 volume of current receivables outstanding totaled approximately $98,487,700 classified as follows [1]

$54,449,000	Motor Lien Retail Time Sales Notes
11,177,000	Motor Lien Wholesale Notes and Acceptances
14,968,000	Industrial Lien Retail Time Sales Notes
15,488,000	Open Accounts, Notes and Acceptances and Rediscounts
1,980,700	Assets (Credit Alliance Corporation) acquired prior to December 31, 1934
425,000	Sundry Accounts and Notes Receivable

The receivables in the first four groups shown above were to mature as follows

$67,072,000	prior to July 1, 1935
21,208,000	during the last half of 1935
6,167,000	during the first half of 1936
1,202,000	during the last half of 1936
433,000	during 1937

[1] Annual Report of company, 1934

Exhibit 1
Commercial Credit Company
Consolidated Balance Sheet

	Dec 31, 1930	Dec 31, 1932	Dec 31, 1934	June 30, 1935
Assets				
Cash	$ 22,365,293	$11,132,475	$ 15,811,101	$ 21,089,945
Motor Lien Retail Time Sales Notes	71,821,599	26,844,788	54,449,131	70,855,849
Motor Lien Wholesale Notes and Acceptances	9,719,525	4,158,919	11,176,967	29,918,711
Industrial Lien Retail Time Sales Notes	40,366,513	25,227,236	14,968,071	16,029,957
Open Accounts, Notes, Acceptances, and Rediscounts	18,768,651	4,683,514	15,488,030	16,773,691
Less Special Reserve for Probable Abnormal Losses		1,200,000 Cr		
Assets Credit Alliance Corp		4,169,513	1,980,699	1,824,960
Investments	2,993,468	1,270,090	578,631	484,513
Other Investments	4,211,798	1,946,295	477,968	849,771
Deferred Charges Interest and Discount Prepaid, etc	868,040	170,277	240,362	408,329
Furniture and Fixtures	8	4	5	5
	$171,114,895	$78,403,111	$115,170,965	$158,235,731
Liabilities				
Unsecured Short-term Notes	$ 64,845,922	$14,746,000	$ 52,844,165	$ 88,743,500
Secured Short-term Notes and Acceptances	11,947,457	483,355	27,433	
Funded Debt after Deducting Amounts Reacquired	12,808,500	9,422,500	2,430,600	2,360,000
Contingent Liability on Foreign Drafts Sold	2,501,883		6,391	252,485
Sundry Accounts Payable Including All Federal and Other Taxes	1,327,177	1,336,574	2,399,411	3,444,760
Manufacturers and Selling Agents, Credit Balance (Textile Co)			4,007,578	4,682,201
Margin Due Customers and Others	13,845,310	5,501,576	4,811,933	5,813,211
Reserves				
For Possible Losses	1,651,613	852,378	2,689,107	3,164,090
For Deferred Interest and Charges (unearned)	5,150,683	2,647,299	4,048,733	5,756,434
Other Reserves	1,000,000	623,103		
Capital Stock and Surplus				
Minority Preferred and Common Stocks, and Surplus (Subsidiary Companies)	4,063,976	1,791,782	1,498,301	74,924
First Preferred Stock 6½ % and 7 %	12,000,000	10,524,750	9,526,150	
Preferred Stock, Class "B," 8 %	4,000,000	3,887,925	3,470,525	
Preferred Stock, 5½ % Convertible, $100 Par Value				19,371,800
Class "A" Convertible Stock, Series A, 6 % (Preference)	12,900,350	9,226,700	7,071,250	
Common Stock*	15,265,452	12,000,000	9,540,520	11,319,320
Capital Surplus	1,050,205	1,160,409	3,145,696	4,028,020
Earned Surplus	6,756,367	4,198,760	7,653,172	9,224,986
	$171,114,895	$78,403,111	$115,170,965	$158,235,731

* Shares changed from no-par to $10-par value, effective June 28, 1933

Note See annual report for each of the above years for amount of Receivables pledged as collateral for Notes Payable and outstanding commitments on foreign exchange

Condensed from Annual Reports of company

EXHIBIT 2

COMMERCIAL CREDIT COMPANY

Consolidated Income Statement, Years Ended December 31

	1930	1932	1934	6 mos ended June 30, 1935
Gross receivables purchased	$330,824,210	$141,640,946	$377,959,031	$267,119,272
Average stockholders investment	58,313,747	46,682 450	40,111,332	43,211,119
Gross earnings	$ 19,655,641	$ 10,398,360	$ 14,213,493	$ 7,757 444
Sundry income	346,009	63,444	51,999	53,835
Discount on notes and debentures retired		275,726	23,018 Dr	
Gross income	$ 20,001,650	$ 10,737,530	$ 14,242,474	$ 7,811,279
Operating expenses (excluding interest and discount)	9,000,960	5,317,643	5,961 845	3,477,571
Federal Excise Tax on capital stock			62,263	
Reserve for losses in excess of net losses	1,985,840 Dr	1,503,268 Dr	364,607	309,556
Reserve for contingencies			900,000	
Special reserve for probable abnormal losses		1,200,000		
Net income before interest and discount	$ 9,014 850	$ 2,716,619	$ 7,682 973	$ 4,643,264
Interest and discount charges	5,038,321	2,390,571	1,368,633	674,458
Reserve for Federal Income Taxes, less credit due to filing consolidated return	99,267	28,066	923 207	623,540
Income of subsidiary not consolidated (Credit Alliance Corporation)	438,954 Cr			
Net income credited to surplus	$ 4,316,216	$ 297,982	$ 5,391,133	$ 3,345 266
Net income on average consolidated capital surplus and undivided profits	7 40 %	0 63 %	13 44 %	15 48 %
Interest and discount charges—times earned	1 78	1 13	5 61	6 88
Net income per share on 6½ % and 7 % First Preferred Stocks (excluding Subsidiary Stocks) outstanding in hands of public, based on $100 par value	$34 67	$ 1 31	$55 30	
Dividends paid thereon—times earned	5 19		8 25	
Net income per share on Common Stock outstanding, end of period	$ 2 03	.	$ 4 11	$2 48

Source Annual Reports of company and Semiannual Report for 1935

EXHIBIT 3

COMMERCIAL CREDIT COMPANY

Condensed Consolidated Summary of Operations

(Including all subsidiaries from date of acquisition)

Calendar year	Gross receivables purchased	Net income before interest and discount charges	Consolidated interest and discount charges: Amount	Consolidated interest and discount charges: Times earned	Net income after all taxes	Average capital and surplus: Invested capital	Average capital and surplus: % Net income on invested capital	Dividends, excluding treasury stock, on First preferred stocks excluding subsidiaries: Amount	Dividends, excluding treasury stock, on First preferred stocks excluding subsidiaries: Times earned	Dividends, excluding treasury stock, on Preferred Class B 8 % and Class A convertible stocks	Balance for common stock
1912*	$ 2,004,842	$ 38,052	$ 7,745	4 91	$ 30,306	$ 304,543	9 95	$ 3,791	7 99	$	$ 26,515
1913	9,413,783	169,294	43,564	3 88	125,729	729,376	17 23	24,500	5 13		101,229
1914	15,011,355	289,540	76,596	3 78	212,943	1,137,309	18 72	35,000	6 08		177,943
1915	17,581,756	188,980	52,046	3 63	136,934	1,509,878	9 06	46,715	2 93		90,218
1916	35,001,972	393,567	82,919	4 72	310,648	2,162,339	14 36	52,500	5 91	27,668	230,479
1917	51,078,171	595,834	237,250	2 51	313,790	2,611,303	12 01	52,500	5 97	52,500	208 790
1918	55,421,258	674,791	334,498	2 01	265,293	2,735,472	9 69	52,500	5 05	52,500	160,293
1919	78,986,426	1,024,725	495,391	2 06	440,263	3,426,733	12 84	53,853	7 52	53,853	297 555
1920	87,291,823	1,851,153	949,430	1 94	742,872	4,859,727	15 28	70,000	9 76	70,000	543,809
1921	79,347,241	1,711,485	852,995	2 00	715,251	5,977,998	11 96	86,376	7 57	93,515	474,109
1922	111,826,475	3,078,382	1,198,439	2 56	1,644,408	7,619,803	21 58	133 185	11 87	152,212	1,295,718
1923	170,384,600	5,364,110	2,696,936	1 98	2,372,567	13,089,240	18 12	210,000	10 95	240,000	1,851,519
1924	162,789,744	4,677,593	2,210,333	2 12	2,165,396	17,209,682	12 58	276,111	7 24	315,555	1,407,481
1925	262,838,156	6,918,961	3,252,510	2 13	3,202,668	19,007,198	16 84	280,000	10 71	320 000	2,400,703
1926†	254,074,662	5,766,719	4,206,834	1 37	1,342,783	29,724,779	4 51	756,666	1 45	320,000	23,959
1927†	204,518,461	5,540,025	3,161,164	1 75	2,067,888	29,354,737	7 04	796,413	2 29	320,000	712,057
1928	265,883,745	8,255,185	3,570,437	2 31	4,132,391	30,318,644	13 62	799 840	4 86	320,000	2,772 800
1929	442,807,262	13,421,415	6,416,208	2 09	6,254,142	48,772,684	12 82	799,890	7 51	715,000	4,496,806
1930	330,824,210	9,014,849‡	5,038,320	1 78	4,316,215	58,313,746	7 40	784,550	5 19	1,184,032	2 110 359
1931	274,358,491	7,353,480	3,458,180	2 12	3,778,406	54,204,501	6 97	744 658	4 80	1,033,503	1,799,470
1932	141,640 946	2,716 619	2,390,571	1 13	297,982§	46,682,450	0 63	723,580	Nil	978,103	1,559,348[d]
1933	199,683,169	4,087,168	1,092,375	3 74	2,951,919	40,590,301	7 27	664,630	4 26	715,065	1,452,167
1934	377,959,030	7,682,972	1,368,633	5 61	5,391,132	40,111,331	13 44	638,218	8 25	700,675	3,929,983
	$3,630,727,578	$90,814,899	$43,193,374	2 10‖	$43,211,926	$20,019,729‖	9 39 %‖	$8 085 476	5 04‖	$7,664 181	$25 004 614

* For 6 months only

† During 1925 the company decentralized its operations into many offices, which caused too rapid an expansion of untrained personnel and resulted in acquiring a considerable amount of undesirable business in 1925 and early 1926 which decreased the net income for 1926 and early 1927

‡ Excludes $438,954 32 net income of subsidiary not consolidated

§ After deducting $1,200,000 special reserve in 1932 for probable abnormal losses

‖ Average for 23 years

[d] Deficit

Source Annual Reports of company

Annual provisions for bad-debt losses varied on the different classes of receivables from ½ of 1% to 1% of the face value of the receivables. In 1934 the actual losses were $382,380 less than the reserves which had been set aside for such losses.

On July 1, 1934, the company called the entire amount outstanding, $2,657,500, of its 5½% Collateral Trust Notes, due July 1, 1935. The only secured debt which appeared on the company's books[1] at the end of the year was an item of slightly over $27,400 on export receivables payable in foreign currencies to avoid exchange risk. Over $52,000,000 of unsecured short-term notes were outstanding as of December 31, 1934, however, and by June, 1935, over $88,000,000 The company had assumed no liability either as to principal or interest for the payment of the 5½% debentures of the Credit Alliance Corporation [2]

At the time when the question of simplifying the capital structure was being considered, Mr A. E Duncan, chairman of the board, made the following statement.

> The capital structure as now constituted has the obvious disadvantage of a number of different issues of preferred stock of several classes and par value, all carrying high dividend rates Existing investment conditions and the excellent condition of the company justify simplification of the present complicated capital structure and dividend rates lower than those on outstanding preferred issues
>
> Upon completion of the plan, the company will have an ideal capital structure, consisting only of convertible preferred and common stocks, with a very sizable reduction in the amount of stock which is preferred either as to assets or as to annual dividends over the common stock [3]

It was argued, also, that inasmuch as reducing the number of classes of stock would reduce the amount of confusion in the minds of investors, the market position of the company's stocks would be improved.

The rapid growth of the company had caused, from time to time, a demand for new money. Business conditions, the strength of the company's credit, and the rates in the money market were major factors influencing the dividend rate on the various stocks which were issued For example, in 1921 when commercial paper

[1] Balance sheets as of Dec 31, 1930, 1932, and 1934, and as of June 30, 1935, are shown in Exhibit 1

[2] Annual Report of company, 1934

[3] *Wall Street Journal*, Mar 5, 1935

EXHIBIT 4
COMMERCIAL CREDIT COMPANY
Ratios of Exchange under Simplification Plan

Classes of securities in respect of which exchange rights are granted by the company				New securities to be issued for *each share* of securities in respect of which exchange rights are granted†				
				5½ % Convertible preferred stock ($100 par value per share)		Common stock ($10 par value per share)		Aggregate of 5½ % convertible preferred stock taken at $102 per share, and common stock, taken at $40 per share, issuable per share
Issue (of Commercial Credit Company unless otherwise indicated)	Number of shares outstanding as of March 29, 1935	Par value per share	Par value plus premium on redemption	Number of shares issuable per share	Preferred stock, taken at $102* per share issuable per share	Number of shares issuable per share	Common stock, taken at $40 per share issuable per share	
6½ % First Preferred Stock	57,224	$100	$110	1	$102 00	16/80	$ 8 00	$110 00
7 % First Preferred Stock	152 150	25	30	1/4	25 50	9/80	4 50	30 00
Class B 8 % Preferred Stock	138,821	25	30	1/4	25 50	9/80	4 50	30 00
Class A Convertible Stock, Series A 6 %	141,425	50	55	7/20	35 70	38/80	19 00	54 70
8 % Preferred Beneficial Interest Shares of Commercial Credit Trust	57,010	25	27 50	1/4	25 50	4/80	2 00	27 50

* Initial public offering price
† Non-dividend-bearing, nonvoting scrip to be issued in lieu of fractions of shares
Source *Prospectus* of 5½ % Convertible Preferred, p 4

EXHIBIT 5
COMMERCIAL CREDIT COMPANY
Effect of Simplification of Capital Structure on Capital Surplus

Recapitalization Credit		
Excess par value of preferred shares retired over par value of 5½% Convertible Preferred and Common Stocks issued in exchange	$797,799 34	
Premium above par value on sale of 14,864 shares of 5½% Convertible Preferred stock not exchanged	29,728 00	
Total Credits		$827,527 34
Recapitalization Expenses		
Premium above par value paid on retirement of Preferred Stocks, not exchanged	$193,575 00	
Legal, accounting, and other expenses	107,366 83	
Underwriters' fees	526,523 00	
Total Debits		827,464 83
Net Credit carried to Capital Surplus Account		$ 62 51

Compiled from Semiannual Report, June 30, 1935

was yielding 6 53% and high-grade bonds, 5 79%,[1] the company issued 8% Class B preferred stock In 1929, when the rate on commercial paper was 5 78% and on bonds, 4 69%,[1] a 6% series was issued by the company A convertible feature was added in 1929 when convertible shares were popular The provisions of the old preferred, of the proposed convertible preferred, and of the common stock issues are given in Exhibit 6.

The plan for the simplification of the company's capital stock proposed that each issue of old preferred be exchanged for new 5½% convertible preferred and common stock equivalent in value to the redemption price specified on each issue of the old preferred stock. The only exception to this plan of exchange was the Class A convertible stock which would receive slightly less than its redemption price The actual ratios of exchange proposed are shown in Exhibit 4

When the refinancing was originally considered it was assumed that a 5% stock would be worth slightly under par and that a 5½% stock would be worth more than par The 5½% dividend rate was chosen on the basis that it would insure the success of the exchange plan and tend to prevent the stock's selling at a low price in the future when money rates would be higher.

[1] *Standard Trade and Securities Statistical Bulletin*, 60 bonds combined

EXHIBIT 6
COMMERCIAL CREDIT COMPANY
Provisions of Capital Stock

	Class of stock	Date of issue	Dividend rate	Par value	Preference, as to	Provisions for conversion	Price of call	Voting power
1	First Preferred Cumulative	1926	6½ %	$100	Assets and dividends shared with (2) over all others	None	$110	Only if 4 quarterly dividends are passed
2	First Preferred Cumulative	1912	7 %	$ 25	Assets and dividends shared with (1) over all others	†	$ 30	Equal with Class B and Common
3	Class B Cumulative	1916 1921	8 %	$ 25	Assets and dividends over Class A and Common	None	$30 after all First Preferred redeemed	Equal with 7 % and Common
4	Class A Convertible Cumulative	1929	6 %	$ 50	Assets and dividends over Common	Convertible into Common, share for share, plus $5 payment	$ 55	Only if 4 quarterly dividends are passed
5	Preferred Beneficial Interest of Commercial Credit Trust, Cumulative	1918	8 %	$ 25	Assets and dividends over Common of Commercial Credit Trust*	None	$ 27 50	
6	(The new) Convertible Preferred Stock, Cumulative	1935	5½ %	$100	Assets and dividends over Common	Convertible into Common, share for share	$110 before June 30 1938, and $105 thereafter	Equal with Common
7	Common Stock	1912		$ 10 since 1933	None	None	None	1 vote per share

* The entire common stock is owned by Commercial Credit Company

† Holders may convert into 6½ % First Preferred according to exchange ratio to be determined by directors

Compiled from Moody's *Banks and Finance* and listing statements with the New York Stock Exchange

The following table shows the market prices of the various issues five days before the final closing date of exchange:

MARKET PRICES

Class of stock	Bid	Asked	Call prices
6½% First Preferred	117¼	118	110
7% First Preferred	32⅛	32⅜	30
Class A Convertible	59⅛	59⅜	55
Class B Preferred	32¼	32⅜	30
Common	44⅞	45⅛	

Source *Wall Street Journal*, May 15, 1935

After the exchange which took place on May 20, 1935, both the new preferred and common stock registered advances in market price. Quotations on selected dates follow

CLOSING PRICES

Date	5½% Convertible preferred	Common
1935		
June 29	112	47⅜
July 20	115	48
Aug 10	119½	53⅜

Source *New York Times*

The changes in capital structure reduced the total par value of the preferred stock by $2,121,375 and annual preferred dividend charges by $388,707 The effect of simplification on capital surplus is shown in Exhibit 5. After all deductions, a small net credit resulted. Underwriters' fees of $526,523 was the largest item of expense. The 1934 net income of $5,391,132 less $1,065,449, the dividend requirement of the new 5½% convertible preferred, would have left $4,325,683, or $4.05 per share on the 1,068,259 shares of common stock outstanding after the exchange. This was 6 cents a share less than the $4 11 a share which was earned in 1934 after dividends on the old preferred stocks. The book value of the common stock, $20,339,388, or $21 31 a share on the 954,052 shares outstanding as of December 31, 1934, would have been $22,460,763, or $21 02 a share on the 1,068,259 shares outstanding, if the exchange had already been effected [1]

The holders of the five preferred issues exercised their exchange rights as follows [2]

[1] *Prospectus* of 5½% Convertible Preferred, p 5
[2] Letter to Stockholders, May 24, 1935

Class of stock	Number of shares surrendered	% Surrendered of total outstanding
6½% First Preferred	53,576	93 6
7% First Preferred	145,771	95 9
Class B Preferred	132,444	95 4
Class A Convertible	122,766	86 8
8% Beneficial Interest Shares of Commercial Credit Trust	51,024	89 5

The balance of 14,864 shares of 5½% convertible preferred was purchased severally by the underwriters[1] Company officials were gratified that not a single vote was cast against the exchange plan, and that 63 9% of the 7% preferred stockholders and 62 5% of the 8% preferred stockholders voted in favor of it, even though it meant accepting a lower yield

Three alternative plans had been considered and rejected by the directors. One plan had proposed the issuance of long-term or short-term debentures to supply the necessary amount, $24,-369,920, for retirement of the preferred stock issues at their respective call prices The chief objection to this plan was based on the fact that it would have reduced invested capital

One of the other plans was to sell a new issue of 5% preferred stock The income from this sale was to have been used to redeem the old issues Another plan proposed raising money for redemption by the sale of stock rights to holders of the company's common stock.

A sale of new securities would have necessitated a substantial write-down of capital surplus since call prices on the old preferred stocks were above par. Under the exchange plan, however, common stock was exchanged at $40 a share, although its stated value was $10 a share. Distribution under this plan created on each share of common stock an excess of $30 a share which was sufficient to avoid any material change in capital surplus.

1. What were the reasons for the proposed simplification plan?
2. Was the adopted plan sound from the company's point of view? Give reasons for your conclusion
3. Why were holders of the old 7% and 8% preferred stock willing to accept the new 5½% stock under the exchange plan?

[1] Letter to Stockholders, May 24, 1935

2. JOHNSON BROTHERS[1]

DETERMINATION OF DIVIDEND POLICY

The directors of Johnson Brothers, manufacturers of tools and brass and iron products, in March, 1926, were undecided as to whether or not a dividend should be paid on the common stock and what general dividend policy should be adopted In November, 1925, the $20-par common stock had been exchanged, share for share, for new no-par common stock. The last two quarterly payments on the common stock which were paid in 1925 amounted to 45 cents per share. The management believed that the dividend policy should be dependent on both the character of the business and the need for additional capital and reserves

Johnson Brothers, incorporated in 1872, manufactured and distributed tools and supplies for gas, water, and oil installations In addition to the main plant in New England and factories in Pennsylvania, Illinois, and Alabama, it had distributing branches in Boston, New York, Chicago, Cleveland, and 13 other large American cities as well as in London and Manchester, England The company had expanded rapidly from 1919 to 1925, since the management believed that factories near market centers were necessary. Johnson Brothers had been prosperous as a local concern for many years, although immediately prior to the expansion it had been losing business to competitors. Under aggressive management, however, Johnson Brothers had established an international business.

By the end of 1925 the expansion program had been completed and there was no immediate need for further capital, although net income was only $2.08 per share and common stock earnings were not yet showing the effects of the expansion. The president was anxious to pay dividends on this common stock as soon as possible since continued failure to pay dividends might cause the stockholders to think the expansion a mistake

Johnson Brothers had paid the following dividends on the old $20-par common stock: $1 30 in 1918, $1 40 in 1919 and 1920,

[1] See Appendix I, "Analysis of Financial Statements," p 348

EXHIBIT 1
JOHNSON BROTHERS
Income Statement, Years Ended December 31
(In thousands of dollars)

	1921	1922	1923	1924	1925
Gross profits	$1,483	$3,324	$4,904	$3,674	$6,585
Administration, selling expenses, and taxes*	2,022	2,151	2,685	2,565	4,330
Depreciation	581	380	394	380	769
Net income	$1,120[d]	$ 793	$1,825	$ 729	$1,486
Interest	303	293	312	309	524
Surplus after interest charge	$1,423[d]	$ 500	$1,513	$ 420	$ 962
Reserve for taxes			79	57	
Profits of subsidiaries					259*
Balance	$1,423[d]	$ 500	$1,434	$ 363	$ 703
Preferred dividends	60	60	60	60	79
Common dividends	35		272	272	311
Surplus	$1,518[d]	$ 440	$1,102	$ 31	$ 313
Earnings per share					
Preferred		$25 03	$71 75	$18 12	$34 17
Common		2 20	6 87	1 51	2 08

[d] Deficit
* Includes net profits of purchased subsidiaries

EXHIBIT 2
JOHNSON BROTHERS
Balance Sheet, as of December 31, 1925
(In thousands of dollars)

Assets		Liabilities	
Plant and Equipment	$16,864	Preferred Stock	$ 1,000
Leaseholds	76	Common Stock and Surplus	15,424
Land Contracts	45	First Mortgage Bonds	8,500
Sinking Fund	13	Debentures	2,500
Investments	34	Subsidiary Preferred Stock	402
Treasury Stock	106	Minority Interest in Subsidiaries	184
Cash	841	Bonds of Subsidiaries	773
Drafts and Notes Receivable	272	Purchase Obligations	471
Accounts Receivable (net)	3,980	Notes Payable	480
Inventories	10,057	Accounts Payable	2,107
Prepaid Items	295	Notes Payable of Subsidiaries	382
Goodwill	419	Reserve for Taxes	117
		Contingency Reserves	662
Total Assets	$33,002	Total Liabilities	$33,002

17½ cents in 1921; none from March, 1921, to March, 1923, 35 cents quarterly from March, 1923, to June, 1925, and 45 cents from September to December, 1925. Earnings on the common stock were $2.08 per share in 1925, as shown in Exhibit 1, the balance sheet for 1925 is given in Exhibit 2 A study of the dividend policies of certain well-known companies, summarized by the treasurer of Johnson Brothers for purposes of comparison, revealed the following information:

The Union Pacific Railroad Company had paid dividends of 10% on its $100-par stock from 1919 to 1925. Earnings meanwhile had fluctuated from $11 73 per share in 1921 to $16 17 in 1924 The range in common stock prices was from $111 in 1922 to $155 in 1923

The North American Company had made quarterly payments of 5% on its common stock from 1909 to July, 1921, in August, 1921, each share of $100-par stock had been exchanged for 1 share of 6% $50-par preferred and 1 share of $50-par common. Quarterly dividends at the rate of 6% had been paid on the common stock in January, 1922, and in April the dividend had been increased to 2½% quarterly, 1½% in cash and 1% in preferred stock From July, 1922, to January, 1923, 2½% cash dividends had been paid quarterly. In April, 1923, the common stock had been reduced to $10 par and 2½% had been paid in common stock In July, 1923, 5% had been paid in cash, but since October, 1923, dividends had been 2½% quarterly in common stock Gross earnings had increased from $38,853,000 in 1921 to $93,029,000 in 1925, while per share earnings on the common stock were $3 11 in 1923, $3 16 in 1924, and $3 12 in 1925 Depreciation charges had increased from $3,240,000 in 1921 to $9,428,000 in 1925

In 1926, dividends of $8 were being paid on the American Locomotive Company's common stock, which had been changed from $100-par value to no-par in June, 1923, when two new shares had been given for each old share An extra dividend of $10 had been paid in 1925 Quarterly cash dividends of 1½% had been paid from 1919 to March, 1923 In June, 1923, 2½% had been paid. On the new no-par shares a quarterly dividend of $1 50 had been begun in September, 1923, and continued to March, 1925, when the regular $2 dividend was inaugurated Earnings on the new stock had been $21.25 per share in 1923 and

$9 80 in 1924 In 1925, however, the company had had a net operating deficit of $688,000 The American Locomotive Company owned $17,687,000 in government securities in 1925 Yearly depreciation from 1921 to 1925 had been approximately $1,500,000

The American Can Company's stock was changed from $100 to $25 par value in February, 1926, and a 50% stock dividend was declared in March. The 1¼% quarterly dividend inaugurated on the $100-par stock in February, 1923, had been continued to February, 1926 Extra dividends of 1% in February, 1924, and 2% in February, 1925, had been paid on the $100-par stock and 3% on the new shares in February, 1926. Prior to 1923 no dividends had been paid and the substantial earnings had been reinvested in the company. From 1921 to 1925 earnings on the old common stock had increased from $2.77 to $32 75 per share. Depreciation was $2,000,000 yearly

The directors of Johnson Brothers were anxious that the company maintain any dividends declared The president considered it a good policy to pay $1 in dividends for each $1 of earnings reinvested in the property The reinvestment of the entire earnings seemed unfair to stockholders who might have purchased the common shares in the expectation of receiving dividends Unless stockholders understood and agreed to such a policy, they were likely to object to having dividends suspended for several years so that rapid expansion might be financed from earnings Several of the directors believed it was wise to finance any large expansion by increased capitalization In their opinion, furthermore, a liberal dividend policy would be a stimulus to the management to develop earnings to maintain it. The directors did not consider it unwise to pay dividends from surplus if conditions were temporarily unfavorable, providing the payment would not seriously affect working capital They believed that a dividend policy should be based on average profits over a period of years Earnings in 1925 and 1926 had been affected adversely by the unusual costs of refinancing and consolidation The management estimated, however, that at least $500,000 would be saved annually through a subsequent lowering of operating expenses, effected to a large extent by a reduction in the number of officials

One plan suggested was that no dividend payment should be made until a reserve fund similar to that of the American Locomotive Company had been built up to insure payment of dividends

during periods of depression Such a policy involved waiting several years before dividends could be paid Furthermore, while Johnson Brothers' earnings fluctuated more sharply than those of companies selling consumers' goods, income was not so variable as that of railroad equipment manufacturers.

Another plan was that dividends be paid in stock as in the case of the North American Company. This policy conserved cash resources and provided for the capitalization of earnings reinvested for expansion of plant Johnson Brothers' business was not expanding in the same way that public utilities were, however, and it was doubtful whether earnings would support a larger capitalization. Stockholders, furthermore, probably would prefer cash to additional stock

One director suggested a quarterly dividend of 15 cents with an extra dividend at the end of the year when profits finally were determined This method permitted determining dividends on the basis of earnings at the end of the year after all charges and reserves had been taken into account This policy would not handicap the company by a large regular quarterly dividend at times when its working capital might be low. On the other hand, it was pointed out that stockholders might prefer more regular payments to meet their expenditures, and that the uncertainty regarding an extra dividend at the end of the year might cause speculation in shares

1. What dividend plan should Johnson Brothers have adopted?

2 Should a company attempt to pay regular dividends when its earnings fluctuate?

3 Should directors submit to stockholders plans for expansion through the reinvestment of earnings?

3 WILSON METALS COMPANY

DIVIDEND POLICY

On April 25, 1934, the directors of the Wilson Metals Company considered whether to declare a cash dividend of 25 cents a share and a stock dividend of 25% on the company's common stock on June 1.

Cash dividend payments of the company from 1930 through the first quarter of 1934 were as follows 1930, 60 cents a share for each of the first 2 quarters and 50 cents a share for each of the last 2 quarters, 1931, 50 cents for each of the first 2 and 37½ cents for each of the last 2 quarters, 1932, 37½ cents for each of the first 2 and 25 cents for each of the last 2 quarters, 1933 through the first quarter of 1934, 25 cents each quarter

Balance sheets and operating statements of the company are shown in Exhibits 1 and 2

The following report to the directors considers various phases of the problem of dividend payments.

To the Board of Directors[1]
Gentlemen·

I am of the opinion that the cash dividend of 25 cents per share should be declared but that the 25% stock dividend should not be declared

In considering the problem I think it best to consider the two proposals separately That can be done because each has a separate effect on the financial position of the company Although both proposals, if put into effect, will alter the financial setup, the cash dividend will have an immediate effect on the financial position, whereas a stock dividend affects only the amounts of the capital and surplus accounts without entailing any immediate outlay of cash As far as the stock dividends are concerned, the net effect is to take part of the surplus and transfer it to the capital account.

25-CENT CASH DIVIDEND

I considered the question of the declaration of the cash dividend from the standpoint of (1) the current financial position of the com-

[1] This report was prepared by a student

pany, (2) the future prospects of the company, and (3) the dividend policy of the company.

EXHIBIT I
WILSON METALS COMPANY
Consolidated Balance Sheet, as of December 31
(In thousands of dollars)

	1930	1931	1932	1933
ASSETS				
Cash	$ 1,007	$ 1,154	$ 1,170	$ 804
Funds Temporarily Invested	94			
Marketable Securities		85	21	56
Notes and Accounts Receivable	854	578	569	675
Inventories	2,056	1,571	1,436	2,440
Total Current Assets	$ 4,011	$ 3,388	$ 3,196	$ 3,975
Buildings, Machinery, etc	6,483	6,128	5,757	5,514
Affiliated Company's Notes and Accounts Receivable	468	308	425	530
Securities	533	439		
Treasury Stock (at Cost)*		62	53	3
Sundry Receivables (Not Current)	56	67	135	121
Deposits	34			45
Cash Value Life Insurance, etc		46	42	
Patents, Trade-marks, etc	1,836	1,835	1,832	1,829
Deferred Assets	240	261	233	279
Total Assets	$13,661	$12,534	$11,673	$12,296
LIABILITIES				
Notes Payable	$ 889	$ 73	$ 120	$ 176
Accounts Payable	281	213	173	293
Accrued Accounts	473	228	166	237
Federal Income Tax		204	154	223
Total Current Liabilities	$ 1,643	$ 718	$ 613	$ 929
Notes for Acquisition of Property (Not Current)	1,505	1,173	793	419
Real Estate Mortgage	420	420	300	300
Accounts Payable—Deferred	72	19		
Reserves for Obsolescence, Contingencies, etc	192	153	145	137
Minority Interest in Subsidiary Company	5	3	2	2
Capital Stock	6,321	6,323	6,323	6,323
Capital Surplus	1,000	1,000	1,000	1,000
Earned Surplus	2,503	2,725	2,497	3,186
Total Liabilities	$13,661	$12,534	$11,673	$12,296

* 6,400 shares, 1931, 5,795 shares, 1932, 370 shares, 1933

The question of the current financial position of the company is the important consideration because the payment of the cash dividend affects that position immediately At the same time, although a

EXHIBIT 2
WILSON METALS COMPANY
Income Account, Years Ended December 31

	1930	1931	1932	1933
Net sales	$12,841,836	$10,489,401	$8,094,147	$8,140,422
Cost of sales, selling, administration expenses	9,999,466	7,989,454	6,194,176	5,890,965
Depreciation and amortization of patents	414,119	466,124	452,854	418,883
Operating profit	$ 2,428,251	$ 2,033,823	$1,447,117	$1,830,574
Other income	44,394	32,007	16,580	31,474
Total income	$ 2,472,645	$ 2,065,830	$1,463,697	$1,862,048
Interest	131,150	121,013	87,273	64,184
Federal tax	224,082	199,165	154,524	222,947
Other deductions	339,140			
Experimental and patent expense		78,495	58,833	67,970
Bad debt, losses on rentals, adjustment of minority interest, etc		156,305	77,237	60,309
Loss on exchange of securities (net)			252,782	
Net profits*	$ 1,778,273	$ 1,510,852	$ 833,048	$1,446,638
Dividends	1,690,515	1,342,797	951,208	762,041
Surplus	$ 87,758	$ 168,055	$ 118,160[d]	$ 684,597
Shares of no-par stock outstanding	768,749	768,474	768,474	768,474
Earnings per share	$ 2 31	$ 1 96	$ 1 08	$ 1 88

* It was announced in April, 1934 that net earnings of the company for the first quarter of 1934 were substantially in excess of earnings for any corresponding period during the preceding four years, and that current business was "running 100 % ahead of last year "
[d] Deficit

cash dividend may be expedient from the standpoint of the present financial position of the company, it may affect any necessary future financing of the company Finally the company must take a long-range view of its dividend policy in order that the stockholders may be reasonably well satisfied, because in the final analysis they are the owners of the business

The current cash position of the company is such that a 25-cent cash dividend can be declared without reducing the cash account below the requirements of the business In the first place it is essential to consider the cash account at this time as compared with the account as shown in the 1933 balance sheet On the balance sheet for 1933 the item cash is $804,000, which is equal to about 20% of the current assets, compared with 25% in 1930 and 36% in 1932. (For a tabulation of some of the important financial ratios for the years from 1930 through

1933, see Table A) The comparison indicates that the proportion of the cash to current assets was relatively low at the end of 1933 The explanation for that lies in the fact that most manufacturers, and it was undoubtedly true of this company, were buying raw material in anticipation of price increases The materials were paid for largely in cash as is shown by the fact that the accounts and notes payable were increased only slightly from 1932 Another evidence that the inventories were high at that time is shown by a comparison of the sales to inventory ratios. At the end of 1933 this ratio was 3 to 1 compared with an average of about 6 to 1 in the previous 3 years Although the previous 3 years were not normal and the inventories were kept low because of falling prices, nevertheless the disparity in the ratios would seem to indicate that the ratio at the end of 1933 was smaller than it would be under normal conditions Therefore, with price increases already in effect and the dangers of any appreciable price increases lessened, it would seem that the ratio of sales to inventory would rise, thus leaving more of the current assets in the form of cash and receivables A further confirmation of this conclusion is found in the statement that business has improved in the first quarter of 1934 as compared with the corresponding quarter in 1933 It must be kept in mind that the comparison is not a good one because the first three months in 1933 were not the brightest three months in the history of business by any means Recognizing that fact, however, there was a fair increase in business, and it is logical to assume that as a result of it the inventories were reduced and converted into cash and receivables Assuming, then, that as a result of improved business and greater price stability, the cash position at the present time is better than it was at the end of 1933 and is approximately equal to the amount held in 1932, a 25-cent cash dividend will not reduce the cash account below the requirements of the business This is true because dividends were paid at the same rate in 1932 without a shortage of cash arising

Table A
Wilson Metals Company
Ratio Analysis

	1930	1931	1932	1933
Current ratio	2 5–1	4 7–1	5 2–1	4 3–1
Acid test	1 1–1	2 4–1	2 8–1	1 6–1
Sales to inventory	6 2–1	6 7–1	5 6–1	3 3–1
Cash to current assets	0 25–1	0 34–1	0 36–1	0 20–1
Sales to working capital	5 4–1	3 9–1	3 1–1	2 7–1
Net worth to debt	2 5–1	4 0–1	5 3–1	5 9–1

Furthermore even if business should increase, the cash position of the company would not be endangered because with an increase in business would come a more rapid turnover of inventory. At the same

time the cash account would become larger because of the added volume of sales, so that the cash position would be increased in proportion to the increase in sales and would ordinarily be enough to take care of the extra cash needed for current expenses

The working capital will not be impaired by the declaration of a 25-cent cash dividend. The current ratio at the end of 1933 was 4 3 to 1 After the dividends are paid, assuming the same ratio of current assets to current liabilities, the ratio would become 4 to 1. From that it can be seen that the working capital would not be affected to any great extent by the declaration of the cash dividend From the standpoint of the working capital as such, dividends larger than 25 cents per share could be declared The difficulty as was shown above lies in the cash position of the company

The prospects for increasing business are such that the dividend payment of 25 cents per share is warranted Business has been increasing since the middle of 1933 The first three months of this year were 100% over the first three months of last year It must be borne in mind that the comparison with the first three months of last year is not a fair indication of the business because the first three months of last year included the bank holiday and were generally pretty poor from the business standpoint Furthermore, even though business at the present time is booming, it might be well to consider the sources of the business It seems pretty obvious that most of the business is the result of the desire of the users of the company's products to lay in supplies before the prices go up as a result of the N R A. codes However, it must be realized that although the present high level is abnormal, the general trend of business should be upward as compared with that done in 1932 and the early part of 1933 The country is beginning to emerge from the depression, and as is usual in such circumstances, business picks up At the same time the relation of increasing costs to profits must not be overlooked The N R A codes are such that there will be an increase in the costs of doing business Therefore, even though business does increase, costs will also increase and unless the margin of profit can be maintained, the profits of the company will be reduced However, the present position is such that the company can pay the cash dividend of 25 cents without running into difficulties It would not be advisable to pay more than that at the present time because the effects of the codes on the profits have not been shown

The payment of the cash dividend will not endanger the prospects for future financing if that becomes necessary If it becomes necessary to borrow from the banks, the banks, in examining the condition of the company, will look at the current ratio, first In this case the current ratio will be 4 to 1 after the cash dividend has been declared That ratio is good from the standpoint of the bank because it is an indication that the company can pay its current liabilities with three times that much over In considering a loan the banks also consider the dividend policy of the company to see that dividends are not paid when such payment endangers the financial position of the company.

That condition will not be true in this case, so it would seem that there will be no argument there from the bankers If the bankers will not lend or the management does not want short-term loans, it may be necessary to sell preferred stocks or bonds The fact that the company has been able to pay a dividend during the depression will have considerable weight in the willingness of the public to buy those securities Even though that dividend is not increased with an increase in earnings, the tendency on the part of the prospective purchaser of bonds or stocks will be to look upon the management as conservative and since they are investing in fixed-income securities, the effect will be favorable As a whole, then, declaring a 25-cent dividend would not put the company in an unfavorable position if it becomes necessary to borrow money for future needs

The policy of the company to pay most of the earnings of the company as dividends will have to be modified because of present conditions During the years from 1930 to 1933 the company paid out most of the earnings in the form of dividends In 1932 dividends were paid out of surplus, but to make up for that in 1933 only about half of the earnings were paid out as dividends In considering the policy of the company it must be remembered that the present increased profits may and probably will be made only during part of the year It stands to reason that after the users have laid in large inventories, they are going to be out of the market for some time. As a result, business will drop off and, consequently, profits For that reason it would be better strategy to pay out only the same amount in the form of dividends as was paid last year, and keep the rest of the earnings as a backlog for the rest of the year when business may not be so good If at the end of the year business is still booming and the prospects look good, then it will be time to consider larger dividend payments It is admitted that the stockholders are entitled to the profits of the company. In the past the company has been very liberal and no stockholder can complain if the company continues its 25-cent dividend policy for the time being The situation might be a little different if there had been no dividends declared in the past few years when they were actually earned But since the earnings were paid out fairly regularly, the fact that there is a temporary increase in the profits is no reason why dividends should be increased so that those profits are absorbed at once.

STOCK DIVIDEND

Stock dividends are ordinarily declared for any one of four reasons according to Gerstenberg [1] They are.

1. To conserve funds for capital expenditures.
2. To distribute the surplus without consuming available cash
3. To reduce the market value of the stock outstanding

[1] [Authors' note C W Gerstenberg, *Financial Organization and Management*, pp. 567, 568.]

4 To prevent an accumulation of surplus that may be subject to taxation by the government

It seems to me that the reason for considering a stock dividend in this case is the second one given above The other three are not pertinent There are to be no capital expenditures The market value of the stock is not high enough to warrant declaring a stock dividend to reduce the market price. Finally the surplus is not such that the government is likely to step in and tax the net income as is the case when the surplus becomes unnecessarily large

I came to the conclusion not to issue the stock dividend, after an analysis of the problem on the basis of (1) the present and future financial position of the company, (2) the problem of future financing, and (3) the stockholders' attitude Here again the financial condition of the company both in the present and in the future is the important consideration The problem of future financing and that of the stockholders' attitude are both contingent on the financial position of the company If the financial condition is not sound, there will be no problem of future financing because there can be none Likewise the financial position affects the stockholder because it affects the returns he gets on his stock

The present effect on the financial statement of the company would be that an amount equal to the proposed increase in capitalization would be transferred from the surplus account to the capital account. It must be borne in mind, however, in transferring part of the surplus to the capital account that the surplus should be a real surplus and not one arising from inflated values of the assets The assets do not seem to be inflated in this case although it is difficult to tell, with the information given It might be well to consider the assets to determine whether or not the book values are real values or not If the book values are inflated so there is really no surplus or very little, obviously there can be no stock dividends, even if there were no reasons other than that for not issuing stock In the absence of proof to the contrary it seems fair to assume that the surplus is a real one and that stock could be issued

As a result of the increased number of shares, if the stock dividend is declared, there will be a tendency to increase the amounts necessary to pay out in the form of dividends. In increasing the number of shares outstanding it will be necessary to pay dividends at the old rate in order to keep the goodwill of the stockholders In other words, if business turns for the worse and an amount is earned which will not warrant the payment of 25 cents on the new total number of shares but would have been enough to pay that much on the old number of shares, it will be necessary to pay only 20 cents per share. Although the stockholder will get the same total amount of dividends, there will be a tendency on his part to consider the new payment a reduction from the old Consequently there will be the temptation on the part of the management to keep the payments at 25 cents when from the standpoint of good management they should really be less Of course

if business increases and the profits likewise go up, there will be no problem But it seems to me that the present outlook is not clear enough to warrant any assumption that there will be any sustained pickup in business. If there is a sustained pickup the stock dividend can be declared later on at a time when the outlook is clearer.

The future financing of the company will be facilitated by having a large surplus. Although the present facilities of the company are adequate for the present needs, it is conceivable that at some future time there will arise the need for some financing either through the banks or through the issuance of stocks or bonds In the case of a bank loan the bank considers not only the current ratios and the business prospects but also the surplus On the whole, if the surplus is large it will be easier to get a loan from a bank because there is greater security, provided of course that the surplus is a real one The same holds true in floating a bond issue or in selling stock It may be argued that any future financing that is necessary may be carried through by borrowing or selling stock to the present stockholders That can be done only when the stockholders are willing and able to do that On the basis of conservatism, then, it is not advisable to issue the stock dividend

The stockholders will really not be gaining anything in the long run by receiving the stock dividend. The effect of the stock dividend is to spread the earnings of the company over a greater number of shares and consequently the dividends per share for any particular period will be less It is admitted that at the present time the stockholder would receive the extra number of shares, but the values of his other shares would be cut down in proportion to the value of the new shares received so that the total value of his shares would be the same, roughly As a usual thing when extra stock is issued, the market value of the stock goes down, especially if the amount issued is comparatively large If the stockholder wishes to sell his stock dividend, then he is really selling part of his capital Although the price drop in the stock is not exactly in proportion to the increase in the number of shares outstanding, it approaches that figure

As a result of the company's policy of paying most of the earnings out as dividends in the last few years, the stockholder is in no position to demand a stock dividend in addition to the regular cash payment During the last four years most of the earnings have been paid out, in one year, 1932, dividends were paid out of surplus Dividends have been paid all through the depression If the situation were such that there had been no payments for the last few years, with earnings being held back, there might be some justification for a stock dividend to distribute the surplus. Although present earnings are above the dividend payments, the uncertainty of the future is reason enough to warrant paying only the 25-cent cash dividend Furthermore, as shown above, it is doubtful if the benefits accruing to the stockholder are enough to warrant going to the expense of arranging for the stock

issue, getting the necessary authorization from the stockholders and having the certificates printed

From a consideration of the proposal to declare a 25-cent cash dividend and a 25% stock dividend I reached the conclusion that it is advisable to pay the 25-cent cash dividend but not advisable to declare the stock dividend The reasons for approving a cash dividend of 25 cents, no more or no less, are governed largely by considerations of the effect of the dividend on the present financial condition, with some consideration given to the question of the effects on the company policy and future financing In the case of the stock dividend the decision hinged largely on the effect of the dividend on the future financial position of the company and the future financing problems The stockholders' attitude is important only in so far as it is the policy of the company to keep their goodwill

1 What changes would you make in the recommendations of the above report?

2 What dividend policy should the directors have followed?

3 Are the ratios of any significance in this problem?

4. FEDDERS MANUFACTURING COMPANY, INCORPORATED

PAYMENT OF ACCUMULATED DIVIDENDS

At the end of August, 1935, the directors of the Fedders Manufacturing Company proposed a plan to settle dividend arrears on the company's 50,000 shares of Class A stock The accumulated dividends on this stock amounted to $575,000, or $11 50 a share, as of July 1, 1935, the full payment of which was necessary before any return could be made on the 50,000 shares of Class B stock owned by the management. Since the company's cash resources were considered insufficient to allow a cash payment of accumulated dividends, the management desired some other means of settling them

The Fedders Manufacturing Company, incorporated in 1913, was located in Buffalo, New York, on the New York Central, the Grand Trunk, and the Delaware, Lackawanna and Western railroads It covered 850,000 square feet of floor space and had over 400 employees in January, 1934 The company had devoted its facilities profitably to the manufacture of honeycomb automobile radiators, until the depression Then because automobile production was reduced and also because the Ford Motor Company was making its own radiators and General Motors Corporation had acquired a large radiator concern, the industry became dependent to a considerable extent upon orders from the Chrysler Corporation As a result, in 1932, the company diversified its products by developing household and commercial refrigerator parts, unit heaters for commercial heating, air-conditioning parts, electric water coolers, and in 1934, steel beer kegs

New products and better business conditions increased sales from $1,781,285 in 1933 to $3,461,301 in 1934, thereby reversing a downward trend that began in 1929. Net income of $88,503 for 1934 compared with a loss of $214,664 for 1933 The only funded debt outstanding at any time was $300,000 in long-term notes issued in 1927 and retired at the end of 1930 Exhibit 1 gives sales and income figures from 1929 to 1934, and Exhibit 2 presents balance sheets for this period

EXHIBIT I

FEDDERS MANUFACTURING COMPANY, INCORPORATED

Comparative Income Account, Years Ended December 31

	1934	1933	1932	1931	1930	1929
Sales	$3,461,301	$1,781,285	$2,163,036	$3,356,534	Not Stated	$6,819,322
Cost and operating expense	3,078,064	1,694,535	1,947,221	3,046,336		6,122,426
Depreciation		93,345	97,824	141,944		123,462
Administrative and selling expenses	209,821	113,214	148,425	217,467		288,509
Operating profit	$ 173,416	$ 119,809[d]	$ 30,436[d]	$ 49,213[d]		$ 284,925
Other income	50,664	53,409	35,785			
Total income	$ 224,080	$ 66,400[d]	$ 5,349	$ 49,213[d]		$ 284,925
Federal taxes	14,389					28,000
Other deductions	121,188	148,264	108,786	107,203		26,296
Net profit	$ 88,503	$ 214,664[d]	$ 103,437[d]	$ 156,416[d]	$154,525[d]	$ 230,629
Earned on Class A	$1 79	Nil	Nil	Nil	Nil	$ 4 61
Earned on Class B	0 21[d]	$ 6 27[d]	$ 4 07[d]	$ 5 13[d]	$ 5 09[d]	2 61

[d] Deficit

Sources Annual Reports of company and Moody's *Industrials*

EXHIBIT 2
FEDDERS MANUFACTURING COMPANY, INCORPORATED
Balance Sheet, as of December 31

	1934	1933	1932	1931	1930	1929
ASSETS						
Current Assets						
Cash	$ 85,203	$ 118,183	$ 235,708	$ 165,648	$ 130,198	$ 219,736
Notes and Accounts Receivable	223,780	90,672	178,449	140,812	187,304	422,844
U S Government Bonds				99,302		17,730
Inventories	486,405	335,333	197,502	195,691	286,405	588,425
Cash Value, Life Insurance					27,207	21,246
Total	$ 795,388	$ 544,188	$ 611,659	$ 601,453	$ 631,114	$1,269,981
Other Assets						
Miscellaneous Receivables, etc	38 378	41,328	50,847	41,467	67,640	
Securities Owned	2,021				1,470	
Fixed Assets						
Land	76,622	76,622	76,622			
Buildings, Machinery, etc	833,641	930,572	1,043,719	1,251,141	1,447,864	1,450,252
Patents	1	1	1	1	4,334	1
Deferred Charges Prepaid Taxes Insurance	12,403	12,781	17,958	20,218	28 990	34,218
Total Assets	$1,758,454	$1,605,492	$1,800,806	$1,914,280	$2,181,412	$2,754,452

EXHIBIT 2 (*Continued*)

FEDDERS MANUFACTURING COMPANY, INCORPORATED

Balance Sheet, as of December 31

	1934	1933	1932	1931	1930	1929
LIABILITIES						
Current Liabilities						
Accounts and Notes Payable	$ 118,614	$ 82,249	$ 59,869	$ 73,040	$ 168,638	$ 255,537
Accrued Accounts	39,767	10,653	9,690	10,063	24,037	64,505
Total	$ 158,381	$ 92,902	$ 69,559	$ 83,103	$ 192,675	$ 320,042
Reserve for Royalties					5,649	
Funded Debt (due Oct 1, 1930)						300,000*
Capital and Surplus						
Capital Stock—No-par Value, 50,000 shares Class A and 50,000 shares Class B	997,650†	997,400‡	1,000,000	1,000,000	1,000,000	1,000,000
Paid-in Surplus	100,000				100,000	100,000
Earned Surplus	502,423	515,190	731,247	831,177	883,088	1,034,410
Total Liabilities	$1,758,454	$1,605,492	$1,800,806	$1,914,280	$2,181,412	$2,754,452

* $300,000 issued in 1927

† Less 600 shares of Class A in Treasury, at cost

‡ Less 650 shares of Class A in Treasury at cost

Sources Annual Reports of company and Moody's *Industrials*

The company's original capitalization in 1913 consisted of 4,000 shares of $100-par common stock held by the Fedders family. On November 24, 1922, a stock dividend of 6,000 shares increased the total number of shares to 10,000. At the end of 1926, the Fedders family decided to sell a half interest to the public, and the company exchanged 50,000 shares of Class A stock and 50,000 shares of Class B stock for the 10,000 shares of common stock held by the Fedders family. The family then sold the 50,000 shares of Class A stock to the public at $25 per share, netting approximately $1,000,000 The Fedders management organized a family holding company, Fedders, Inc, to hold the Class B stock and to manage the proceeds from the sale of Class A stock to the public

During the depression, Fedders, Inc, took advantage of the low market price of Class A stock and purchased 10,000 shares with part of the proceeds from the original sale of that stock, thus increasing the interest of the Fedders family in the business to 60%. On December 31, 1934, 600 shares of Class A stock were held in the treasury of the Fedders Manufacturing Company There were 496 Class A stockholders as of February 17, 1934, and six company officers and directors owned all the Class B stock

In the event of liquidation, the Class A stock was entitled to $25 a share in preference to Class B and participated equally with Class B after the latter had received $25 a share. The Class A had cumulative preference of $2 a share in dividends, and participated equally with Class B after $2 a share was distributed to the latter in any one year. No dividends might be paid on Class B stock that would reduce net quick assets below $750,000. Both classes of stock had equal voting power.

The company encountered adverse business conditions in 1930 and suffered a deficit of $3 09 per Class A share in that year Consequently, no dividends were disbursed after October 1, 1929 By July 1, 1935, Class A dividends had accumulated to $11 50 per share On Class B stock $1 per share was paid in 1927 and $2 in 1928 In the annual report for 1934, Mr. Fedders stated that the problem of Class A dividends must be deferred, as cash had to be closely guarded to meet taxes and to maintain the company's credit for seasonal borrowings During the year 1934, cash declined from $118,183 to $85,203, and the company's condition was as shown in Exhibit 2

Sales reached $3,214,370 and net profit $202,576 in the first seven months of 1935, however, and the management believed some action should be taken on dividend arrears. Mr. Fedders stated the problem as follows:

> The difficulty facing us is the lack of cash to bring up to date the dividends already accumulated on the Class A stock so that the management which owns the other half of the company (50,000 shares of Class B stock) may get some recognition for its accomplishments.[1]

As a solution, the owners of the Class B stock proposed to turn over one-half of their holdings or 25,000 shares to the Class A stockholders in settlement of dividend arrears. The management regarded one-half a share of Class B as fair payment of $11 50 in dividend arrears, since according to Mr Fedders, "the market value of the Class B was approximately $20" Just before the plan was announced, Class A shares sold on the New York Curb Exchange for $21.[2]

Under the proposed plan, there would be 100,000 shares of only one class of no-par common stock The Class A stockholders would renounce their priority right to dividends, but on the other hand would own 75% of the company and share in 75% of its earnings. The Class B stockholders would share at once in the company's profits.

On adoption of the plan, the directors proposed to declare a quarterly dividend of 25 cents on the new stock This dividend rate would be equivalent to $1 50 a year on each Class A share, as Class A shareholders would own 75% of the new stock.

The company considered the issuance of bonds or preferred stock in payment of dividend arrears as unsound The issuing and carrying expense, the management felt, would simply add to the company's burden, thereby reducing prospects for dividends on the Class B shares.

1. Was the proposed plan of settling dividend arrears fair to the Class A stockholders and in line with good financial policy in 1935?

2 Should Class B stockholders have favored the proposed plan? Why?

[1] Letter to stockholders, Aug 31, 1935
[2] *New York Times*, Aug 10, 1935

5. ALPHA PORTLAND CEMENT COMPANY

REDEMPTION OF PREFERRED STOCK AND PURCHASE OF COMMON STOCK IN THE OPEN MARKET

During the years from 1930 to 1935, many companies retired their preferred stock issues and purchased a substantial number of shares of their common stock in the open market. Cumulative dividend requirements on preferred issues were considered burdensome in view of the low earnings during the depression. Purchase and redemption of preferred issues therefore seemed a profitable use for funds not needed in the business Similarly, the purchase of common stock selling far below its par or stated value provided an opportunity to use funds which would not safely earn a substantial return

The Alpha Portland Cement Company afforded a good example of this type of financial policy. At the annual meeting in October, 1934, the stockholders voted to redeem the company's $2,000,000 issue of $100-par, cumulative $7 preferred stock at a premium of 25% as stipulated in the charter In July, 1935, they voted to retire 66,400 shares of no-par common stock that had been purchased in the open market during the previous few years

The Alpha Portland Cement Company was organized in 1910 as a combination of several smaller concerns Until 1929 the company carried out a program of expansion, reaching a position as fourth among the six largest producers in the industry, the two major acquisitions of property took place in 1922 and 1928 From 1929 on, the company continued to hold its position as fourth largest producer, with an annual capacity of approximately 13,000,000 barrels of cement The company operated plants in the ten principal markets east of the Mississippi River, the two largest plants were located at Martin's Creek, Pennsylvania, and at Alpha, Missouri Raw materials were quarried from the company's own properties, comprising 6,493 acres of land. The principal product was gray Portland cement which was sold

under the advertised name of "Alpha" Sales offices were maintained in eight cities in the United States

Marketing areas in the cement industry were limited by relatively high transportation costs due to the great weight of the product The plants of the Alpha Portland Cement Company were strategically located with regard to markets Another important characteristic of the industry was the large fixed

EXHIBIT 1
ANNUAL PRODUCTION AND PERCENTAGE OF CAPACITY OPERATED IN THE CEMENT INDUSTRY, AND PERCENTAGE OF CAPACITY OPERATED IN ALPHA PORTLAND CEMENT COMPANY

Year	Cement Industry*		Alpha Portland Cement Company
	Amount of production (Unit 1,000 bbl)	Per cent of capacity	Per cent of capacity†
1925	161,659	83 5	
1926	164,530	76 4	
1927	173,207	73 9	
1928	176,299	72 3	
1929	170,646	65 9	
1930	161,197	59 7	
1931	125,429	46 1	41
1932	76,741	28 3	32
1933	63,373	23 0	25
1934	77,682	29 0	

* Bureau of Mines, U S Department of Commerce
† Company reports Figures for only 3 years are available

investment required for economical operation and the resulting need of volume production Annual production of cement and the percentage of capacity operated are shown in Exhibit 1. The industry depended upon a few large fields of consumption, with heavy construction and highway construction taking approximately 60% of the total output Construction contracts awarded for the last 10 years were as shown in Exhibit 2. The outlook for 1935 indicated a larger sales volume for cement, for the government program of public works was getting under way and improvement in business conditions was probable The recent reduction in import duties on Belgian cement was an adverse factor, competition would, however, be confined to the Atlantic seaboard so that

the Alpha Portland Cement Company would not be seriously affected.

The company's sales of over $4,712,000 in 1934 exceeded the sales of 1933 by almost $638,000, enabling the company to report a smaller loss than for the three preceding years. A net loss of $163,000 for 1934 compared favorably with deficits of $779,000 in 1931, $1,764,000 in 1932, and $750,000 in 1933. Income statements for the years ended December 31, 1929 through 1934,

EXHIBIT 2

ANNUAL CONSTRUCTION CONTRACT AWARDS IN 37 STATES EAST OF THE ROCKY MOUNTAINS

Year	Number of contract awards	Year	Number of contract awards
1925	6,006,432	1930	4,523,112
1926	6,380,916	1931	3,092,844
1927	6,303,060	1932	1,351,359
1928	6,628,284	1933	1,256,601
1929	5,750,796	1934	1,543,533

Source Poor's *Survey of Industries*

are shown in Exhibit 3 With annual depreciation and depletion charges of $1,400,000 and with capital expenditures at a low level, the company maintained a strong financial position Net working capital at the close of 1934 amounted to over $5,000,000, which did not include $2,500,000 in cash that had been set aside for retirement of the preferred stock Current liabilities were only $404,000. Balance sheets as of December 31, 1929 through 1934, are presented in Exhibit 4.

Capitalization as of December 31, 1934, consisted of 20,000 shares of $100-par $7 cumulative preferred stock, and 644,600 shares (excluding 66,400 in the treasury) of no-par common stock Exhibit 5 shows the changes that had taken place in the common stock capitalization since the company was organized The company never had any funded debt Preferred dividends were paid regularly. The payment of 25 cents a share on the common stock in January, 1935, was, however, the first payment since April, 1932. Book value per common share was $34.19 at the end of 1934, as against $35 50 the previous year.

Those in favor of redeeming the company's preferred stock argued that cash resources were larger than necessary for current

EXHIBIT 3
ALPHA PORTLAND CEMENT COMPANY
Comparative Consolidated Income Account, Years Ended December 31

	1929	1930	1931	1932	1933	1934
Net sales	$11,368,968	$9,936,821	$6,012,601	$3,857,756	$4,074,835	$4,712,352
Operating expenses	7,288,122	6,593,622	5,001,808	3,860,468	2,987,054	3,221,420
Depreciation and depletion	1,369,984	1,390,312	1,410,589	1,441,032	1,443,924	1,452,904
Maintenance and repairs	1,203,141	890,376	603,145	417,982	379,140	405,126
Net operating loss	$ 1,507,721*	$1,062,511*	$1,002,941	$1,861,726	$ 735,283	$ 367,098
Other income (net)	307,297	185,842	223,990	85,084	25,459[d]	195,511
Loss	$ 1,815,018*	$1,248,353*	$ 778,951	$1,776,642	$ 760,742	$ 171,587
Minority interest (credit)				13,026	10,930	8,820
Net loss	$ 1,815,018*	$1,248,353*	$ 778,951	$1,763,616	$ 749,812	$ 162,767
Preferred dividends	140,000	140,000	140,000	140,000	140,000	163,333
Common dividends	2,133,000	1,599,750	711,000	171,475		161,150
Deficit for year	$ 457,982	$ 491,397	$1,629,951	$2,075,091	$ 889,812	$ 487,250

* Income
[d] Deficit
Source Moody's *Industrials*

operations of the business It was considered unsound for a manufacturing concern to enter the investment business on a substantial scale. Furthermore, the Banking Act of 1933 abolished interest on demand deposits, and the return on time deposits was negligible. Short-term government securities were quoted

EXHIBIT 4
ALPHA PORTLAND CEMENT COMPANY
Comparative Consolidated Balance Sheet, as of December 31

	1929	1931	1933	1934
Assets				
Current Assets				
Cash	$ 2,914,835	$ 3,478,716	$ 2,168,254	$ 1,506,230
Certificates of Deposit		20,000		
U S Government Securities	1,357,975	2,528,613	2,764,943	1,949,563
Other Marketable Securities			1,041,140	691,116
Call Loans	2,600,000			
Working Funds etc	217,988	146,416	158,541	129,311
Notes and Accounts Receivable	399,150	639,668	295,533	235,536
Inventories	2,895,380	1,723,839	1,365,523	973,896
Total Current Assets	$10,385,328	$ 8,537,252	$ 7,793,934	$ 5,485,652
Fixed Assets				
Property	21,932,994	19,787,956	17,541,004	16,863,109
Investments (cost)	273,039	296,766	223,835	97,070
Reacquired Stock (cost)		228,965	545,133	731,345
Reserve for Preferred Stock Redemption				2,500,000
Deferred Charges	138,317	159,569	93,406	79,800
Total Assets	$32,729,678	$29,010,508	$26,197,312	$25,756,976
Liabilities				
Current Liabilities				
Accounts Payable	$ 328,951	$ 162,195	$ 169,632	$ 159,802
Wages Payable	35,460	8,925	12,443	14,104
Accrued Taxes	268,061	43,194	61,803	45,646
Dividends Payable	533,250	177,750		184,483
Total Current Liabilities	$ 1,165,722	$ 392,064	$ 243,878	$ 404,035
Preferred Stock	2,000,000	2,000,000	2,000,000	2,500,000
Common Stock	24,134,500	18,486,000	18,486,000	18,486,000
Minority Interest			65,543	56,723
Compensation and Insurance Reserve	599,731	601,308	603,134	603,473
Other Reserves	114,238	30,701	37,643	25,444
Surplus	4,715,487	7,500,435	4,761,114	3,681,301
Total Liabilities	$32,729,678	$29,010,508	$26,197,312	$25,756 976

Source Annual Reports of company and Moody's *Industrials*

on a very low yield basis The premium of $500,000, which would have to be deducted from surplus, was not considered excessive in view of the fact that annual preferred dividends of $140,000 would be eliminated

The 66,400 shares of no-par common stock which the company proposed to retire had been purchased in the open market during the years 1931 to 1934. In 1931, 21,500 shares were bought in at an average cost of $10 65 a share, in 1932, 18,500 shares at

$7 41 a share, in 1933, 14,600 shares at $12 26 a share, and in 1934, 11,800 shares at $15 78 a share The total cost involved aggregated $731,345, and the average cost per share equaled $11 01

The retirement of these shares held in the treasury would reduce the stated value of the common stock by $26 for each share retired, or by a total of $1,726,400, which was $995,055

EXHIBIT 5
ALPHA PORTLAND CEMENT COMPANY
Changes in Common Stock Capitalization

Date of issue	Purpose of issue	Number of shares	Stated value
Jan 10, 1910	Organization of company	80,000 $100-par	$ 8,000,000
Oct 13, 1920	Stock dividend (25%)	20,000 $100-par	2,000,000
Oct 13, 1920	Purchase of properties	58,000 $100-par	5,800,000
Oct 21, 1925	Stock dividend (25%)	39,500 $100-par	3,950,000
		197,500	$19,750,000
Oct 21, 1926	An exchange for 197,500 shares of $100-par	592,500 no-par	19,750,000
May 4, 1928	Securing cash	118,500 no-par	4,384,500
		711,000	$24,134,500
Total issued Jan , 1935		711,000 no-par	18,486,000*
In treasury		66,400 at cost	731,345
Net		644,600	$17,754,655

* In 1931 the stated value was reduced from $24,134,500 to $18 486,000
Source Standard Statistics Company

greater than the cost of their purchase This excess, derived from buying in the company's own stock at prices less than the stated value, would be added to surplus

1. What factors should the company consider in deciding whether to retire its preferred stock? Was the decision in line with sound financial policies?

2. Would your analysis be different for the purchase of common stock in the open market?

3 Was there any connection between the purchase of common and preferred stock by this company? What was the effect on the surplus account?

6 NATIONAL STEEL CORPORATION

REFUNDING OF OUTSTANDING BONDS

In May, 1935, the National Steel Corporation proposed to sell a new $50,000,000 issue of First (Collateral) Mortgage Sinking Fund Bonds, 4% Series, which would be due June 1, 1965. The company intended to apply $38,850,000 of the proceeds to redeem at 105% its First (Collateral) Sinking Fund Gold Bonds, 5% Series, due 1956, then outstanding in the principal amount of $37,000,000 The company also intended to advance $2,216,667 to the Weirton Coal Company, a wholly owned subsidiary, to be used by the latter to retire its first mortgage bonds The balance of the new issue would be used to increase working capital and reimburse the corporation for capital expenditures to be made, principally for the construction of a new strip steel sheet mill near Detroit

The prospectus for the proposed bond issue described the company as follows

> National Steel Corporation was organized November 7, 1929, under the laws of the State of Delaware As of December 1, 1929, it acquired all the stock of the Weirton Steel Company, Great Lakes Steel Corporation, and Hanna Iron Ore Company of Delaware The latter company had previously acquired from the M A Hanna Company (Ohio) the stocks of certain subsidiaries and other companies owning and operating iron ore and blast furnace properties and lake vessels Subsequently the stocks of certain of such subsidiaries were transferred to the Company, and the blast furnace properties owned by one of such subsidiaries were transferred to the Great Lakes Steel Corporation

Since 1929, the company had added new products and additional facilities Net fixed assets rose from $68,578,535 in 1929 to $99,972,562 in 1934. The company's expansion was financed partly by a $40,000,000 bond issue in 1931 In 1934 the company was the sixth largest producer in the domestic steel industry Strip steel and strip steel sheets accounted for more than one-fourth of the company's finishing capacity Other important

products were plates, sheets, bars, structurals, and tin plate The company was the second largest producer of tin plate in the industry

The company's largest markets were provided by the automobile industry and by the manufacturers of containers The products of this company were used also by the building trade and by manufacturers of electrical refrigerators, steel furniture, and railroad equipment

The company operated profitably throughout the depression; net income for 1934 was $6,050,722, or $2 81 per share, compared with $2,812,407, or $1 30 per share for 1933 (see Exhibit 1).

EXHIBIT 1
NATIONAL STEEL CORPORATION
Sales and Income, Years Ended December 31

Year	Gross sales, less discounts, returns, and allowances*	Total income before deductions	Depreciation and depletion	Interest charges	Net income before dividends
1929					$12,573,683
1930		$13,151,367	$2,605,284	$ 803,840†	8,415,822
1931		10,192,697	3,117,404	2,115,853	4,443,324
1932	$43,603,761	7,031,026	3,089,913	2,128,015	1,662,920
1933	60,821,508	8,392,209	3,091,680	2,005,459	2,812,407
1934	76,328,569	12,880,692	3,653,743	1,970,071	6,050,722

**Prospectus* issued May 28, 1935, on the $50,000,000 First (Collateral) Mortgage Sinking Fund Bonds
† Bond discount deducted from interest in 1930
Compiled from Annual Reports of company

Net working capital increased by $6,168,062 during 1934 so that at the close of the year it amounted to $33,932,493, of which $11,479,821 was in cash Other changes also are shown by the balance sheets which appear in Exhibit 2

Funded debt at the close of 1934 consisted of approximately $37,000,000 in first mortgage 5% bonds, due June, 1956, and $2,333,333 in first mortgage 5% bonds of the Weirton Coal Company, which were payable dating from January 31, 1930, in 30 semiannual installments of $116,667 After the proposed refinancing, funded debt would comprise only the new issue of $50,000,000 in 4% bonds Further description of the existing funded debt and of the proposed bond issue is given in Exhibit 3

EXHIBIT 2
NATIONAL STEEL CORPORATION
Consolidated Balance Sheet, as of December 31

	1929	1930	1931	1932	1933	1934
ASSETS						
Cash	$ 6,855,847	$ 1,388,363	$ 3,755,774	$ 6,215,432	$ 6,776,766	$ 11,479,821
Marketable Securities						1,500,000
Notes and Accounts Receivable, Less Reserve	7,572,300	6,728,236	7,621,046	5,681,371	5,372,595	7,417,460
Inventories	18,793,142	23,005,926	23,864,137	20,629,705	21,656,018	21,111,836
Total Current Assets	$ 33,221,289	$ 31,122,525	$ 35,240,957	$ 32,526,508	$ 33,805,379	$ 41,509,117
Other Assets	908,043	908,124	680,285	776,611	1,064,403	903,572
Investments	11,858,794	13,270,695	13,939,879	13,409,063	13,212,529	13,241,434
Properties, Less Reserve	68,578,535	89,333,066	104,032,805	101,598,202	101,147,648	99,972,562
Deferred Charges	907,527	1,528,191	3,629,887	1,565,917	1,497,455	809,434
Capital Stock Subscriptions Receivable	5,354,570					
Total Assets	$120,828,758	$136,162,601	$157,523,813	$149,876,301	$150,727,414	$156,436,119
LIABILITIES						
Current Liabilities	$ 12,240,456	$ 19,367,067	$ 7,460,409	$ 3,446,493	$ 6,040,948	$ 7,576,624
Funded Debt—Parent			40,000,000	39,000,000	36,995,000	36,966,000
Funded Debt—Subsidiaries	9,821,532	10,206,257	3,033,333	2,800,000	2,566,667	2,333,333
Minority Interest	523,708	12,734				
Reserves	2,863,141	2,176,132	2,581,408	2,365,266	2,388,421	2,951,339
Capital Stock	51,800,000	53,743,350	53,920,800	53,920,800	53,920,800	53,894,425
Earned Surplus	961,862	5,116,454	4,865,734	2,829,211	4,294,257	8,189,202
Capital Surplus	42 618,059	45,540,607	45,662,129	45,514,531	44,521,321	44,525,196
Total Liabilities	$120,828,758	$136,162,601	$157,523,813	$149,876,301	$150,727,414	$156,436,119

Compiled from Standard Corporation Records

EXHIBIT 3
NATIONAL STEEL CORPORATION
Additional Information on Funded Debt

BONDS OUTSTANDING DECEMBER 31, 1934

1 *National Steel Corporation First (Collateral) Mortgage Sinking Fund Gold Bonds, 5% Series, Due 1956*

Dated—April 1, 1931

Sinking Fund—Payable annually beginning not later than October 1, 1932, sufficient to retire by call $1,000,000 bonds plus 2½% of bonds, series due 1956, issued in addition to original issue Bonds may be tendered in lieu of cash Bonds so acquired to be canceled

Callable—As a whole at any time on 60 days' notice, or in part on any interest date on 30 days' notice at

105 to April 1, 1936, inclusive,
104 to April 1, 1941, inclusive,
103 to April 1, 1946, inclusive,
102 to April 1, 1951, inclusive,
101 to April 1, 1955,
and at 100 thereafter

Bonds may also be retired from the sinking fund

Amount of Original Issue—$40,000,000

Outstanding—$36,966,000

2 *Weirton Coal Company 5% First Mortgage Bonds*

Dated—July 31, 1929

Principal payable in 30 equal semiannual installments commencing January 31, 1930

Amount of Original Issue—$3,500,000

Outstanding—$2,333,333

PROPOSED BOND ISSUE

National Steel Corporation First (Collateral) Mortgage Sinking Fund Bonds, 4% Series, Due 1965

Dated—June 1, 1935

Sinking Fund—$1,000,000 annually, each October 21, commencing in 1936, either in cash or in bonds at face amount Any cash so paid to be applied by the trustee on the succeeding December 1 to the redemption of the 4% bonds, by lot, on 30 days' notice, at the following prices

102½ to December 1, 1940, inclusive,
102 to December 1, 1945, inclusive,
101½ to December 1, 1950, inclusive,
101 to December 1, 1955, inclusive,
100½ to December 1, 1960,
and at 100 thereafter, in each case with accrued interest

Redeemable—Except for the sinking fund, as a whole at any time on 60 days' notice or in part by lot on any interest date upon 30 days' notice at the following prices

105 to June 1, 1940, inclusive,
104 to June 1, 1945, inclusive,
103 to June 1, 1950, inclusive,
102 to June 1, 1955, inclusive,
101 to June 1, 1960, inclusive,
100½ to June 1, 1964, inclusive,
and at 100 thereafter, in each case with accrued interest

Amount to Be Issued—$50,000,000

Condensed from Poor's and Moody's *Industrials* and from *Prospectus* issued May 28, 1935, by the National Steel Corporation

The proposed issue would be sold through the following underwriters:[1]

Name	Principal amount	Percentage
Kuhn, Loeb & Company	$20,000,000	40%
Brown, Harriman Company, Inc	13,000,000	26
White, Weld & Company	7,000,000	14
Lee, Higginson Corporation	3,500,000	7
Edward B Smith & Company	2,000,000	4
The First Boston Corporation	2,000,000	4
Kidder, Peabody & Company	1,500,000	3
Field, Glore & Company	1,000,000	2

The underwriters would buy the proposed issue from the company for $49,000,000, or 98% of the $50,000,000 principal amount The public offering price would be $50,250,000,[2] or 100½% of the principal amount, leaving a total underwriting discount of $1,250,000, or 2½% of the principal amount The underwriters proposed to offer part of the bonds to a selling group at the public offering price less a discount of 1¼% of the principal amount The latter would sell to the public at the public offering price [3] The net proceeds to the company would be $48,638,250, after deducting expenses incident to the issue but exclusive of accrued interest

The proposed issue was a first lien on all the capital stock of the following subsidiaries [4]

Great Lakes Steel Corporation	1,000 shares
Hanna Furnace Corporation (New York)	59,101
Hanna Iron Ore Company of Delaware	1,000
Michigan Steel Corporation (Inactive)	1,000
Midwest Steel Corporation	11,250
The Producers Steamship Company	1,000
Weirton Coal Company	12,300
Weirton Steel Company	1,000

[1] *Prospectus* issued May 28, 1935, on the National Steel Corporation's $50,000,000 First (Collateral) Mortgage Sinking Fund Bonds, p 15.

[2] Plus accrued interest to date of delivery

[3] Any member of the selling group might make a concession to any investment banker registered under Article X of the Amendment to the Code of Fair Competition for Investment Bankers, provided such investment banker intended to redistribute the bonds to his clients

[4] *Prospectus* issued May 28, 1935, on the National Steel Corporation's $50,000,000 First (Collateral) Mortgage Sinking Fund Bonds, p 7

In addition there were pledged outstanding demand mortgage bonds of the following subsidiaries [1]

Company	Principal amount pledged
Weirton Steel Company	$40,000,000
Great Lakes Steel Corporation	30,000,000
Michigan Steel Corporation	6,000,000
The Hanna Furnace Corporation (Delaware)	2,000,000*
The Hanna Furnace Corporation (New York)	2,000,000
Weirton Coal Company	2,000,000
Total	$82,000,000

* Dissolved, bonds assumed by Great Lakes Steel Corporation

The new issue would also have a lien on additional demand mortgage bonds to be issued by the following subsidiaries

Weirton Coal Company (approximately)	$ 2,216,000
Weirton Steel Company (approximately)	1,434,000
Great Lakes Steel Corporation (approximately)	12,000,000
Total	$15,650,000

The grand total of all demand mortgage bonds pledged would be $97,650,000 These bonds would have a first lien on substantially all the properties owned by subsidiaries of the National Steel Corporation

The indenture of the proposed issue gave adequate protection to the bondholders in regard to a sinking fund, redemption provisions, priority, additional issuance of bonds, release of fixed assets, common stock dividends, and default on interest or principal

An executive of the company stated that no alternative refunding plans were considered because of the level of interest rates and the condition of the money market in general Furthermore, no objections were raised to the proposed refunding plan

1 Describe in detail the new bonds to be issued

2 Was the proposed plan of refinancing more satisfactory than alternative methods that might have been followed?

[1] *Prospectus* issued May 28, 1935, on the National Steel Corporation's $50,000,000 First (Collateral) Mortgage Sinking Fund Bonds, p 7

7 CHRYSLER CORPORATION

REFINANCING—SUBSTITUTION OF BANK NOTES FOR BONDED DEBT TO REDUCE INTEREST CHARGES

On March 14, 1935, the directors of the Chrysler Corporation voted to redeem on May 1, 1935, the $30,150,500 issue of 6% debentures of Dodge Brothers, Inc This issue, which would mature in 1940, constituted the company's only funded debt In order to redeem these bonds, the officers of the company arranged to borrow $25,000,000 from depository banks on one-, two-, three-, four-, and five-year notes distributed equally among the five maturities The balance was paid by the company in cash. The Chrysler Corporation's cash had been increasing during 1934, its daily cash balances were over $40,000,000

The loans evidenced by these notes were regular bank loans arranged between the company and the individual banks without any underwriting Although no statement was made concerning the rates at which these loans were obtained, it was understood that they averaged approximately 2½% The company reserved the right to retire the notes in full or in part without premium at any time at its option, subject only to 30 days' notice and to the provision that the notes of the longest maturity should be retired first

According to Mr Chrysler, the new arrangement would accomplish the following

> . . . effect a saving in interest to the company of approximately $1,200,000 a year after the first year, which is equivalent to 28 cents a share on its common stock outstanding The maturity of these notes in the amounts of $5,000,000 a year during the next five years will provide for an orderly liquidation of a debt which would have had to be met at the maturity in 1940. This annual retirement amounts to substantially less than half the corporation's annual amortization and depreciation charges[1] in recent years and thus does not constitute a material drain upon the corporation's cash reserves.

[1] See Exhibit 1

When Mr. Chrysler took over the management of the Maxwell-Chalmers Company in 1921, it was in a poor condition. Debts of more than $20,000,000 were maturing, only 50 dealers remained, 26,000 unsold cars constituted practically frozen assets, and the plant was badly run down Under his management, within 3 years a reconstructed chain of 2,000 dealers sold 50,000 Maxwell cars and 32,000 Chryslers. The plant was modernized out of profits, and a $5,000,000 cash balance built up. In 1925, one

EXHIBIT 1
CHRYSLER CORPORATION
Consolidated Income Account, Years Ended December 31

	1931	1932	1933	1934
Sales	$183,805,104	$136,546,522	$238,675,951	$362,254,625
Cost of sales*	159,439,359	126,613,346	201,966,050	318,898,896
Gross profit	$ 24,365,745	$ 9,933,176	$ 36,709,901	$ 43,355,729
Add				
Interest and miscellaneous income	1,952,815	1,669,162	1,719,985	1,720,943
Total income	$ 26,318,560	$ 11,602,338	$ 38,429,886	$ 45,076,672
Deduct				
Administrative and sales expense	20,944,952	20,064,266	20,154,594	30,860,170
Interest and premium charges	3,143,314	2,792,304	4,087,264	2,834,643
Income taxes	118,414		2,058,909	1,847,023
Other expense	642,945			
Net profit	$ 1,468,935	$ 11,254,232[d]	$ 12,129,119	$ 9,534,836
Less				
Dividends paid	4,412,240	4,390,243	4,303,567	5,432,235
Balance	$ 2,943,305[d]	$ 15,644,475[d]	$ 7,825,552	$ 4,102,601
* Depreciation and amortization charged to cost of sales and expenses	$ 14,296,852	$ 13,239,026	$ 13,127,419	$ 12,450,953

[d] = Deficit
Source Annual Reports of the company, 1931–1934

year and a half after the first Chrysler was exhibited, the Maxwell name and line were dropped The Maxwell properties were taken over and the Chrysler Corporation was formed

Chrysler Corporation continued to expand steadily. In 1928 the corporation acquired the business, properties, and dealer organization of Dodge Brothers, Inc , and also created the De Soto and Plymouth Motor Corporations By the end of the year a complete line of cars representing every price range was being produced by Chrysler Corporation Thus Chrysler Corporation not only rounded out its lines of passenger cars (later augmented by Dodge trucks) but entered aggressively and successfully the

lowest-price car market then dominated by two manufacturers The growth of Chrysler Corporation is indicated by the number of cars sold (see Exhibit 2)

In the Dodge Brothers acquisition, a debt of $59,455,000 was assumed Of this total, $56,705,000 was in 6% gold debentures, redeemable at 105, with a sinking fund provision calling for the retirement of $1,000,000 out of earnings each year

By November, 1934, the Chrysler Corporation had repaid the $20,000,000 debt of the former Maxwell Company and had also retired almost half of the debentures of Dodge Brothers, Inc

EXHIBIT 2

SALES OF TRUCKS AND PLEASURE CARS IN THE UNITED STATES

Year	Units sold by Chrysler Corporation*	Total new registrations in United States†
1926	170,392	3,614,398
1927	192,083	2,951,503
1928	360,399‡	3,480,702
1929	450,543	4,407,263
1930	269,899	3,036,678
1931	272,118	2,222,025
1932	222,512	1,276,812
1933	451,734	1,739,663
1934	598,884§	2,292,443‖

* Standard Statistics Company, April 1, 1935, C61-12
† *Automobile Facts and Figures*, National Automobile Chamber of Commerce 1934, p 8
‡ Includes Dodge Brothers sales from July 31, 1928
§ Includes marine engines, etc
‖ *Automotive Industries*, February 23, 1935, p 242

The Chrysler Corporation had no bank loans outstanding at the end of 1934 and had not borrowed from banks for many years The financial condition of the company from 1931 through 1934 was as shown by the consolidated balance sheets in Exhibit 3.

The Chrysler Corporation announced on June 10, 1935, that it would pay off on July 6, 1935, in anticipation of maturity, $5,000,000 of the $25,000,000 loan arranged several months previously with its depository banks The notes to be paid off were the $5,000,000 of five-year notes due May 1, 1940, which had the highest interest rate of the five maturities The payment of these notes would reduce the company's outstanding debt, other than current liabilities, to $20,000,000 It was stated that

EXHIBIT 3
CHRYSLER CORPORATION
Consolidated Balance Sheet, as of December 31

	1931	1932	1933	1934
ASSETS				
Current Assets				
Cash and Marketable Securities	$ 50,232,836	$ 42,602,494	$ 37,369,976	$ 32,415,843
Drafts	1,983,957	2,956,058	435,292	6,597,377
Accounts and Notes Receivable	1,909,023	1,745,779	2,277,681	10,541,684
Inventories	22,104,294	18,377,465	34,556,769	37,533,615
Total Current Assets	$ 76,320,110	$ 65,681,796	$ 74,639,718	$ 87,088,519
Sinking Fund Cash	640	20,342		500,000
Other Assets	9,653,689	9,160,081	10,774,994	9,856,504
Permanent	65,513,327	61,696,540	60,409,225	59,356,384
Goodwill	25,000,000	1	1	1
Deferred	2,121,896	1,827,943	1,693,711	2,157,867
Total Assets	$178,609,662	$138,386,703	$147 517,649	$158,959,275
LIABILITIES				
Current Liabilities	$ 11,327,696	$ 16,395,380	$ 21,222,605	$ 37,686,371
Funded Debt	44,411,500	42,331,000	40,026,500	30,150,500
Reserve for Contingencies, etc	6,730,782	4,543,418	4,418,763	5,299,239
Capital				
Capital Stock	73,122,488	21,847,205	21,807,135	21,728,940
Capital Surplus		25,896,979	24,844 373	24,793,350
Earned Surplus	43,017,196	27,372,721	35,198,273	39,300,875
Total Liabilities	$178 609 662	$138,386,703	$147,517,649	$158,959,275

Source Annual Reports of company, 1931–1934

such payment would also effect a saving in interest of approximately $150,000 annually over the following 5 years.

1 Was the method of refinancing followed by the Chrysler Corporation as satisfactory as alternative methods which it might have employed?

2. Give specific reasons for the company's plan of refinancing

8 HANDYSIDE OIL COMPANY

PROPOSAL TO RETIRE OR REFUND BONDED DEBT

The Handyside Oil Company was established in 1914 to engage in all branches of the oil business Originally it had small holdings in Oklahoma, but subsequently widened its acreage until it owned or controlled over 250,000 acres of oil and gas lands in Oklahoma, Kansas, and Texas. The company owned 2 oil refineries and 15 natural gasoline refining plants Its retail distribution was handled through 500 owned service stations in one large eastern district In 1928 the company put out a $10,000,000 issue of 5½% sinking fund gold debentures and paid a stock dividend of 50%. Between 1928 and 1935 the only significant change in the company's capital structure was the reduction of $2,000,000 in the amount of bonds outstanding Balance sheets and operating statements are shown in Exhibits 1 and 2

In May, 1935, in order to take advantage of the lower interest rates then prevailing, the Handyside Oil Company considered means of refunding the debentures These debentures would not mature until 1943, but they were callable at 101¼ The two most feasible procedures were, in short, that the company borrow from its bank sufficient capital on time loans to enable it to redeem the bonds, or that the company bring out a new refunding issue at a lower rate of interest

The Handyside Oil Company could borrow from its banks at a very low rate of interest on time loans which would be payable over a five-year or six-year period The company's bankers stated that the cost of such borrowing would probably not average more than 2% or 3% annually since the interest on short-term notes was considerably lower than that on long-term notes If the company borrowed from the banks, it could repay its indebtedness as rapidly as it desired

The company could, on the other hand, refund the debentures by selling a new 10-year issue at a lower rate of interest. Invest-

EXHIBIT I

HANDYSIDE OIL COMPANY

Consolidated Balance Sheet, as of December 31

	1930	1931	1932	1933	1934
ASSETS					
Cash	$ 5,328,514	$ 2,637,124	$ 3,556,604	$ 2,183,779	$ 3,080,006
Marketable Securities (at Market)	97,786	10,682	8,613	5,936	
Accounts Receivable, Less Reserve	2,905,654	2,251,887	1,837,186	1,856,430	2,629,577
Notes and Acceptances Receivable	395,891	292,414	225,288	203,788	
Crude and Refined Products (at Market)	6,697,377	5,602,486	5,361,678	7,418,894	7,253,340
Materials and Supplies	1,894,691	1,544,785	1,352,409	1,391,376	1,548,570
Total Current Assets	$ 17,319,913	$ 12,339,378	$12,341,778	$13,060,203	$14,511,493
Employees' Stock Purchase Warrants	1,454,465	163,245	112,366	40,328	
Investments in Subsidiaries	4,114,245	7,566,809	1,153,642	1,019,385	1,049,717
Prepayments	731,787	719,546	771,785	593,434	669,972
Property, Plant, and Equipment, Less Reserves	83,591,171	79,892,792	74,828,020	70,755,261	68,496,313
Total Assets	$107,211,581	$100,681,770	$89,207,591	$85,468,611	$ 84,727,495
LIABILITIES					
Accounts Payable	$ 2,342,867	$ 1,529,587	$ 1,631,020	$ 2,174,339	$ 1,973,359
Notes Payable (Secured)		1,843,202	1,074,116		
Other Notes Payable	5,882,500	4,669,500	1,618,587		
Dividends Payable	1,069,995				
Accruals	995,388	1,341,816	1,228,199	1,059,790	1,438,057
Notes Receivable Discounted	*	*	568,952	493,064	299,459
Total Current Liabilities	$ 10,290,750	$ 9,384,105	$ 6,120,874	$ 3,727,193	$ 3,710,875
5½ % Sinking Fund Gold Debentures, Due in 1943	10,000,000	9,500,000	9,000,000	8,500,000	8,000,000
Vinoil Company 6% Debentures, Due in 1940	1,391,750	1,059,250	802,750	618,500	
Deferred Purchase Obligations	967,547	1,187,870	1,714,487	1,047,994	482,975
Reserve for Contingencies	259,881	297,108	392,945	573,152	754,307
Capital Stock and Surplus	84,301,653	79,253,437	71,176,535	71,001,772	71,779,338
Total Liabilities	$107,211,581	$100,681,770	$89,207,591	$85,468,611	$84,727,495

* Contingent liability in 1930, $3,675,000, in 1931, $415,000

EXHIBIT 2
HANDYSIDE OIL COMPANY
Condensed Statement of Income, Years Ended December 31

	1930	1931	1932	1933	1934
Net income after interest and taxes	$10,044,954	$7,416,063	$9,616,889	$ 9,447,576	$10,490,618
Less Inventory adjustments to market	1,322,365	689,475	310,596	1,160,364 (cr)	
	$ 8,722 589	$6,726,588	$9,306,293	$10,607,940	$10,490,618
Less Intangible development costs	669,272	1,243,617	1,143,543	1,596,577	1,121,661
Depletion and lease amortization	1,965,537	3,012,414	2,189,775	2,264,605	1,825,403
Depreciation, retirements, and other amortization	4,567,465	5,258,761	5,585,092	5,996,410	4,664,900
Total reserves and retirements	$ 7,202,274	$9.514,792	$8,918,410	$ 9,857,592	$ 7,611,964
Net profit	$ 1,520,315	$2,788,204[d]	$ 387,883	$ 750,348	$ 2,878,654
Less Dividends paid	3 222,200				2,076,504
Profit after dividends	$ 1,701,885[d]	$2,788,204[d]	$ 387,883	$ 750,348	$ 802,150

cr = credit
[d] Deficit

ment bankers believed that they could sell the proposed new bonds to yield $4\frac{1}{2}\%$ to $4\frac{3}{4}\%$ Their charge for underwriting and distributing the bonds would be 4% of the face value of the issue The saving in interest made possible by this plan would, then, be substantial although not so great as under the alternative. By borrowing at a fixed rate for a longer period of time the company

EXHIBIT 3
HANDYSIDE OIL COMPANY
Statistics of the Petroleum Industry

Year	Crude Petroleum		Gasoline	
	Production*	Price†	Production*	Price†
	Monthly average (in millions of barrels)	Average for 10 oil fields (in dollars per barrel)	Monthly average (in millions of barrels)	Average of one price weekly at refining centers (in cents per gallon)
1925	63 65	$1 843	21 63	12 43¢
1926	64 17	2 028	24 98	11 76
1927	75 09	1 519	27 54	8 28
1928	75 13	1 524	31 42	9 05
1929	83 92	1 684	36 62	8 44
1930	74 83	1 455	36 73	6 88
1931	70 92	0 879	36 48	4 64
1932	65 15	0 961	33 26	5 19
1933	74 91	0 840	34 02	4 35
1934	75 78	1 157	36 45	4 59

Source Standard Statistics Company, *Standard Trade & Securities*, compilation of data from
* U S Bureau of Mines
† *Oil, Paint, and Drug Reporter*

would be in less danger of the notes' coming due at a time when payment might embarrass the company

Both methods of refinancing were common in 1935 The executives of the Handyside Oil Company believed that the outlook for their company as well as for the industry (see Exhibit 3) was such that the risk would not be exceedingly great if bank loans were used Several of the older officers in the company hesitated to favor this plan, however, because of their past experience in operating with a limited working capital The treasurer believed that the large charges being made annually for depletion, lease amortization, and depreciation would assure the company of

liquid funds even though no net profit were made The Handyside Oil Company made charges for depreciation on plant and equipment at the rate of 6% to 30%, and for depletion according to the regulations of the Federal Government, it charged off development expenses annually

What policy should the company adopt regarding its outstanding debentures?

9 CLEVELAND TRACTOR COMPANY[1]

FINANCIAL MANAGEMENT

The world-wide depression of 1921, following as it did an unhealthy and abnormal business boom, found the Cleveland Tractor Company with large inventories, large plant capacity, and inadequate permanent working capital, as shown in the balance sheet and operating statement in Exhibits 1 and 3 In 1920, sales were $12,599,156 as compared with $974,106 in 1917. The fixed investment of the company in land, buildings, machinery, and equipment had increased from $543,815 to $3,099,555 In 1917, the ratio of sales to permanent assets had been 1 79 and in 1920 it was 4 07, simultaneously the ratio of sales to inventory had increased from 2 48 to 4 10 (see Exhibit 4)

In spite of these favorable changes, there were already signs that the original capital of the business was insufficient As shown in Exhibit 4, the current ratio had gradually fallen from 2 02 to 1 38, and the ratio of cash and accounts receivable to current liabilities, the "acid test," had declined from 0 71 to 0 52 Moreover, 1919 and 1920 indicated a relative increase in receivables, as the ratio of sales to receivables, which had been 9 64 in 1918, was 7 69 in 1919 and 8 96 in 1920 These changes seemed to indicate that too large a volume of business was being done in proportion to the owners' capital involved

Sales suddenly dropped to $3,363,605 in 1921 and declined to $2,130,424 in 1922, so that the lack of working capital greatly endangered the business One of the directors of the company lent $775,000 to the company, conceding a preferential creditor position to the lending banks Borrowings from banks had to be increased To make the bank loans more secure, the company created a first mortgage issue of about $2,000,000 which it gave the banks as collateral for what had hitherto been unsecured lines of credit. Thus, although the current ratio increased to 1 74

[1] See Appendix I, "Analysis of Financial Statements," pp 346–349

EXHIBIT 1
CLEVELAND TRACTOR COMPANY
Condensed Balance Sheet, as of December 31
(In thousands of dollars)

	1917	1918	1919	1920	1921	1922	1923	1924	1925	1926	1927	1928
ASSETS												
Cash	$ 64	$ 103	$ 472	$ 420	$ 259	$ 93	$ 38	$ 241	$ 273	$ 211	$ 472	$ 381
Notes and Trade Acceptances Receivable, Less Reserves	} 148	} 692	53	31	940	357	63	20	40			497
Accounts Receivable, Less Reserves			1,080	1,375	1,079	304	200	126	114	238	351	471
Inventories, Less Reserves	392	1,606	2,226	3 078	1,921	2,037	1,363	744	829	724	909	1,436
Other Receivables										17	31	
Total Current Assets	$ 604	$2,401	$3,831	$4,904	$ 4,199	$2,791	$1,664	$1,131	$1,256	$1,190	$1,763	$2,785
Land		$ 187	$ 334	$ 335	$ 1,014	$1,014	$1,014	$1,014	$ 955	$ 954	$ 954	$ 954
Buildings, Machinery, and Equipment, Less Reserves	$ 543	1,183	1,704	2,765	3,236	3,286	3,066	2 807	2 586	2 380	2 218	2 292
Total Permanent Assets	$ 543	$1,370	$2,038	$3,100	$ 4,250	$4,300	$4,080	$3,821	$3,541	$3,334	$3,172	$3,246
Other Assets		219	64	134			209	228				
Unpaid Stock Subscriptions, Less Reserves	532	82	552	327	50	43	43					
Deferred Assets	23	26	173	119	66	42	32	69	25			55
Tractor Development							2		67	274	181	88
Goodwill	64	64	79	81	1,500	1,521	1,505	1 505	1,505	1 505	1,505	1,505
Total Assets	$1,766	$4,162	$6,737	$8,665	$10,065	$8,697	$7 535	$6,754	$6,394	$6,303	$6,621	$7,679
LIABILITIES												
Accounts Payable	$ 234	$ 498	$ 483	$ 294	$ 219	$ 179	$ 86	$ 62	$ 55	$ 163	$ 235	$309
Customers' Deposits			237	289	132	123	53	50	39			25
Accrued Interest Taxes, and Insurance		11	23	61	79	117	60	51	50	52	55	54
Notes, Borrowed Money, and Other Liabilities	64	1,280	1,916	2,904	3,162	1 188	212	7	32			
Total Current Liabilities	$ 298	$1,789	$2,659	$3,548	$ 3,592	$1,607	$ 411	$ 170	$ 176	$ 215	$ 290	$ 388
Bank Loans Secured by Mortgage						1,700	2,144	2,058	1,940	1,940	1,940	1,940
Personal Loans Payable and Accruals					500	775	876	927	970	1,018	1,065	1,112
Reserves for Service Adjustments					14	5	2		1			57
Reserve for Contingencies and Federal Taxes		225	90	75	478	98	51	28	18	40	80	155
Reserve for Foreign Shipments												171
Capital Stock	1,468	2,148	3,988	5 042	5,481	4,512	4 051	3,571	3,289	3,090	3 246	3,856
Total Liabilities	$1 766	$4,162	$6,737	$8,665	$10,065	$8,697	$7,535	$6,754	$6,394	$6,303	$6,621	$7 679

Source Condensed from company reports

in 1922, a funded debt[1] had been incurred which was larger than the proprietary interest in the company. After deducting good-

EXHIBIT 2
CLEVELAND TRACTOR COMPANY
Condensed Balance Sheet, as of September 30
(In thousands of dollars)

	1928	1929
ASSETS		
Cash	$ 590	$ 77
U S Government Securities		1,265
Notes, Accounts, and Trade Acceptances Receivable, Less Reserves	612	1,017
Inventories, Less Reserves	1,319	1,951
Total Current Assets	$2,521	$4,310
Land	954	352
Buildings, Machinery and Equipment, Less Reserves	2,260	1,952
Total Permanent Assets	$3,214	$2,304
Other Assets	175	475
Goodwill	1,505	
Total Assets	$7,415	$7,089
LIABILITIES		
Accounts Payable	$ 456	$ 691
Accrued Interest, Taxes, and Insurance	422	193
Total Current Liabilities	$ 878	$ 884
Bank Loans Secured by Mortgage	1,940	
Notes Payable to Individual	775	
Reserve for Contingencies and Federal Tax	79	375
Reserve for Foreign Shipments		278
Stated Capital	4,944	3,329
Capital Surplus	1,964	1,375
Profit and Loss Surplus	3,165[d]	848
Capital Stock	$3,743	$5,552
Total Liabilities	$7,415	$7,089

[d] Deficit
Source Condensed from company reports

will from the proprietary interest as shown on the balance sheet, the ratio of worth to debt was 72 The ratio of sales to fixed assets declined to 0.50 and the ratio of sales to inventory to 1 05

[1] This "funded" debt was really a current liability further secured by mortgage notes However, since most of the notes were dated 1930, it has been considered throughout this report as an ordinary mortgage issue

EXHIBIT 3

CLEVELAND TRACTOR COMPANY

Condensed Profit and Loss Statement, Years Ended December 31

(In thousands of dollars)

	1917	1918	1919	1920	1921	1922	1923	1924	1925	1926	1927	1928	1929‖
Net sales	$974	$6,655	$8,708	$12,599	$3,363	$2,130	$2,355	$1,680	$1,808	$3,001	$4,415	$7,368	$8,616
Cost of sales	910	5,222	6,650	9,460	2,434	1,715	1 916	1,625	1,452	2,299	3,305	5,230	5,777
Manufacturing profit	$ 64	$1,433	$2,058	$ 3,139	$ 929	$ 415	$ 439	$ 55	$ 356	$ 702	$1,110	$2,138	$2,839
Selling expense		453	1,210	1,172	1,252	845	400	218	206	294	352	523	629
General and administrative expense		334	218	209	177	100	75	52	55	64	75	97	137
Fixed uncontrollable expense							178		106				
Depreciation		169	169	243		63			166	277	291	330	330
Advertising										113	129	152	199
Miscellaneous expense				782*	48	67	60		11	47		12	71
Total expenses		$ 956	$1,597	$ 2,406	$1,477	$1,075	$ 713	$ 270	$ 544	$ 795	$ 847	$1 114	$1,366
Operating profit		477	461	733	548[d]	660[d]	274[d]	215[d]	188[d]	93[d]	263	1,024	1,473
Interest		43	67	124	165	209	204	183	156	145	143	257	200
Corporation and stock tax						10	8		4	2	2	2	4
Adjustments on sale of assets		3	120	7		35	19	41	1	2	3	2	
Reserves for doubtful accounts		51	39	49				11					
Special discounts to dealers		50			97						22‡	81‡	
Miscellaneous deductions				274†	25	60	139	25	10	3	4	55	61
Total other deductions		$ 147	$ 226	$ 454	$ 287	$ 314	$ 370	$ 260	$ 171	$ 152	$ 174	$ 397	$ 265
Cash discounts				25	9	2	8	7	9	18	28	49	53
Other income		7	53	30	42	6	24	68	58	19	30	97	136
Total other income		$ 7	$ 53	$ 55	$ 51	$ 8	$ 32	$ 75	$ 67	$ 37	$ 58	$ 146	$ 189
Federal tax adjustments		225	50	34	250						5 cr		
Inventory cost—market adjustment	$ 40				287					10 cr			
Other adjustments	24				207					1 cr		170§	
Net profit		$ 112	$ 238	$ 300	$1 528[d]	$ 966[d]	$ 612[d]	$ 400[d]	$ 292[d]	$ 197[d]	$ 152	$ 603	$1,397

* Parts department costs
† Development costs $157,000
‡ Provision for Federal income tax
§ Deferred profit on foreign credits

‖ As of Sept 30 for 12 months
[d] Deficit
cr = Credit
Source Condensed from company reports

After the new arrangement with the banks, the two problems which required immediate attention were reduction of inventory and collection of receivables. The ratio of sales to receivables was 1 67 in 1921, but by 1924 this ratio had improved to 11 50 partly because the company promptly took necessary losses. The ratio of sales to inventory showed steady improvement after 1922

By 1925, the maladjustments caused by the depression had been corrected with the exception of the mortgage notes and the over-extended plant. The current ratio had increased to 7 15 and the ratio of cash and receivables to current liabilities was 2 43, sales to receivables 11 75, and sales to inventory 2 18 Thus, the current and credit positions were satisfactory and the inventory position improved Because of the steady losses, however, the ratio of worth to debt had declined to 0 57.

EXHIBIT 4
CLEVELAND TRACTOR COMPANY
Financial Ratios, as of December 31

Year	Current assets / Current liabilities	Cash & receivables* / Current liabilities	Net worth / Debt	Sales / Fixed assets	Sales / Receivables	Sales / Inventory
1917	2 02	0 71	4 69	1 79	6 56	2 48
1918	1 34	0 44	1 04	4 86	9 64	4 14
1919	1 44	0 61	1 42	4 27	7 69	3 92
1920	1 38	0 52	1 37	4 07	8 96	4 10
1921	1 17	0 63	0 87	0 79	1 67	1 75
1922	1 74	0 47	0 72	0 50	3 22	1 05
1923	4 05	0 73	0 73	0 58	8 95	1 73
1924	6 66	2 28	0 65	0 44	11 50	2 26
1925	7 15	2 43	0 57	0 51	11 75	2 18
1926	5 53	1 70	0 49	0 90	11 75	4 15
1927	6 10	2 94	0 79	1 39	11 55	4 86
1928	7 19	3 48	0 72	2 27	7 62	5 13
1929†	4 87	2 67	3 60	3 74	8 47	4 41

* Acid Test Ratio
† As of Sept 30

In 1925 new models were developed Sales increased rapidly, thus improving plant utilization By 1928, the ratio of sales to fixed assets was 2 27 as compared with 0 44 in 1924 The profits accruing from the new business increased the proprietary interest and improved the worth-to-debt ratio to 0 72. All other ratios continued to reflect the improved conditions. It is interesting

EXHIBIT 5

CLEVELAND TRACTOR COMPANY AND SUBSIDIARY

Income and Expense for the Year Ended September 30, 1929

Manufacturing profit before deducting depreciation		$2,553,409 28
Selling, general, and administrative expense		960,643 46
Operating profit before deducting depreciation		$1,592,765 82
Less		
Depreciation	$329,556 16	
Interest on borrowed money	91,971 37	
Other charges (net)	52,109 75	$ 473,637 28
Profit before providing for Federal Taxes		$1,119,128 54
Provision for Federal Taxes		149,000 00
Net profit		$ 970,128 54
PROFIT AND LOSS—DEFICIT—SURPLUS		
Profit and Loss—Deficit Sept 30, 1928		$3,165,590 56
CREDITS		
Net profit from operations for the period of three months ended Dec 31, 1928	$121,935 70	
Depreciation for the period of three months ended Dec 31, 1928, charged against operating results, applied as a reduction of unearned surplus	16,854 20	138,789 90
		$3,026,800 66
SPECIAL CHARGES AS OF JANUARY 1, 1929		
(Exclusive of charges to unearned surplus for elimination of appreciation and intangible assets)		
Charging off balance of intangible assets	$464,365 96	
Additional provision for contingencies	200,000 00	
Writing off deferred development expense	88,033 23	
Providing for expenses pertaining to refinancing and reorganization	50,000 00	802,399 19
		$3,829,199 85
Less Provision for elimination of deficit by a charge against capital surplus, as authorized by board of directors		3,829,199 85
Balance as of Jan 1, 1929		$ 0
Net profit from operations for the fiscal year ended Sept 30, 1929, as shown by statement of income and expense	$970,128 54	
Less Net profit for the period from Oct 1, 1928, to Dec 31, 1928	121,935 70	
Balance representing net profit from Jan 1, 1929, to Sept 30, 1929		$ 848,192 84
Profit and loss—surplus Sept 30, 1929		$ 848,192 84

Source Company report

to note that, after the inauguration of the more aggressive marketing policy and the entrance into new markets, there was a decline in the sales-to-receivables ratio probably reflecting the greater need for credit extension under such conditions It was possible that a ratio of 11 or 12 was far too high, and that the company had failed to get all the business it should

The ratios for 1929 were not comparable with those for preceding years because they were based on conditions at a different season of the year.

In September, 1929, the fiscal year was changed to end September 30. The company also simplified its balance sheet by eliminating appreciation on permanent assets and intangible items For comparative purposes the balance sheet as of September 30, 1928, is shown in Exhibit 2 with that of September 30, 1929 Exhibit 5 shows the operations by means of which the changes in capital surplus were made on the balance sheet as of September 30, 1929.

At the same time accounting policies were adopted which corresponded with the general practice of widely-held corporations The company also retained adequate reserves on accounts receivable and on inventories The usual reserves were maintained for taxes and contingencies and a large reserve was created on certain of its foreign accounts Developmental costs were charged to current operating expenses as they occurred and depreciation was taken at the following rates.

Buildings	3%
Building improvements	10
Furniture and equipment	10
Tools, jigs, dies, and patterns	25
Machinery	7
Autos, trucks	25
Vendors' tools, jigs, and dies	25

In February, 1929, the company undertook to obtain new capital and to revise the capital structure of the business. The financial position of the company had improved as indicated previously, so that the flotation of securities was possible. The mortgage notes which fell due in July, 1930, would have to be met either by payment through the issue of further common stock or by refunding. In February, 1929, however, bond issues were in disfavor and equities popular with the investing public.

The company decided against a refunding bond issue, therefore, and adopted the following method

1	Issued one new share for each old share held	49,442
2	Number of shares outstanding February, 1929	49,442
	Number after 2-for-1 split	98,884
3	Rights[1] issued to purchase 1¼ for 1 at $32 a share	121,116
	Capitalization after issue	220,000

The price on the common stock in 1929 never exceeded 34¾, and the new rights had little value In April, 1929, Otis & Company, the underwriter, offered at $32 a share the 96,000 shares which were not subscribed by the old stockholders. Although the stock was not active, wide distribution was obtained by the offering firm Earnings per share after adjustments for non-recurring interest charges had been $1 19 in 1927, $3 33 in 1928, and $4 41 in 1929[2] Shares were listed on the New York Curb Exchange An initial dividend of 40 cents a share was paid on January 15, 1930

1 What major financial problems were faced by the management of the company from 1917 to 1929?

2 Were these problems wisely met?

3 What is the significance of each set of ratios in Exhibit 4?

4 What were the advantages and disadvantages of the methods used to meet the mortgage notes which fell due in July, 1930?

SUMMARY QUESTIONS

1. What is meant by the "capitalization" of a company?

2. What should its objectives be?

3 Why do companies purchase their own common and preferred stock? When is this a sound policy? Is there any difference in policy between a company's purchase of its bonds and of its stocks?

4 What leads to the statement that there is a "style" cycle in corporate financing? Give examples

5 What interest does the investing public have in the capitalization of a corporation?

READINGS

DEWING, A S *The Financial Policy of Corporations* 3d rev ed New York Ronald Press Company, 1934 Book V "Expansion," Chap 7 "Financial Plan of an Expanding Corporation," pp 931–953

[1] Major stockholders waived 2,489 rights

[2] Year ended Sept 30, 1929; other years ended Dec 31

DOLLEY, J C "Characteristics and Procedure of Common Stock Split-Ups," *Harvard Business Review*, Vol XI, No 3 April, 1933, pp 316–326

"Coe Utilities Company" (Refunding) *Harvard Business Reports*, Vol 5 New York, McGraw-Hill Book Company, Inc , 1928, pp 7–12

LINCOLN, E E *Applied Business Finance* 4th ed , rev New York McGraw-Hill Book Company, Inc , 1929 "Dividends," pp 712–720

MONTGOMERY, R H , editor *Financial Handbook* 2d ed New York Ronald Press Company, 1933 "Stock Rights," pp 538–544

SIEGEL, S N "Stock Dividends," *Harvard Business Review*, Vol XI, No 1, October, 1932, pp 76–87

VI

VALUATION AND COMBINATION

The rapid growth of scientific achievement beginning before the turn of the present century, together with the rapid growth of a developing nation which had both an expanding population and a large export trade, has resulted in a constant flux in business organization to meet the needs of our mass production industries. Small businesses have grown into large ones, large ones have grown into gigantic organizations integrated both horizontally and vertically. One business has merged with another or has been bought outright, and whole groups have been united to form single enterprises Chain organizations and holding company structures have developed to finance or to control the far-flung enterprises of modern business

Complicated problems of valuation have arisen in connection with welding together the various units going into the make-up of a larger organization The assets or the ownership equities of the concerns involved must be valued beforehand, otherwise there would be no basis for amalgamation

Value is an elusive quality, for it is subjective rather than objective Measures of value exist only as the result of mental or emotional reactions Value is not a physical quality like texture, weight, or color, but depends mainly upon human judgment Hence, value must often be described in relation to the purpose of the valuation or in terms of the person or persons making the valuation We find it usually necessary, therefore, to apply some descriptive adjective to the word "value," with the result that we have sales or exchange value, tax value, going-concern value, reproduction value, cost value, liquidation value, junk value, sentimental value, nuisance value, and many others. Each of the above values might be quite different depending upon its purposes and, furthermore, individuals in a group might each place a different estimate from that placed by the others upon any one of the above types of value. Occasionally one can

approach the subject logically and rationally, cost value, for instance, can often be built up accurately from cost records Going-concern value, however, is subject to no exact formula satisfactory to everyone, yet each may believe that his own "feel" of value is more reliable than the figures justified by any other equally competent individual.

The kind of value to be dealt with in this chapter, namely, exchange value for the purposes of business combination, can be arrived at only by a spirit of give-and-take, of compromise, and of reconciliation, on the part of the various interests involved

Sometimes combination involves placing a value upon a concern's securities, sometimes it involves primarily valuing its physical assets When the ownership is being transferred through exchange or sale of a company's securities, the business is taken over as a going concern with whatever values may accrue through the fact of continuing customer relations, continuing contractual obligations, franchises, indentures, rights and agreements, and the thousand and one elements that go to make up the going-concern business Sale of assets, however, usually involves merely a valuation of the physical properties to be taken over from the going concern, which may wind up its affairs, liquidate its obligations, surrender its charter, and go out of business as a corporate entity The decision as to which method, that of absorbing the securities, or only the assets, of a concern, depends upon the advantages and disadvantages inherent in the particular situation

Valuation of assets is usually based on a direct physical appraisal, but even here it is largely a matter of human judgments, and the difficulties involved in the case of a large and complex property are limitless. The value of physical property depends upon the uses to which it may be put, the extent to which other types of property may be better suited to the requirements of the proposed uses, the extent of obsolescence and, depreciation, estimated future costs, and countless other factors

In determining valuation for a corporate entity, the difficulties may be even greater. The problems of valuing physical properties are complicated by the more intangible factors of the corporate organization and of the existing contracts and obligations, by the company's corporate structure and the various rights inherent in the ownership of its securities In the final analysis the most

important factor determining the value of a going concern is its estimated future earnings Future earnings depend upon general business conditions in the future, conditions within the industry in the future, and conditions within the specific concern in the future, and—a factor of great importance—estimates of such earnings depend on the judgment of the individual making the valuation.

Certain analyses may be helpful in the preliminary stages of valuation Significant balance sheet and income statement ratios may be helpful [1] It is generally advantageous to ascertain the trend of inventory turnover and receivables turnover, the adequacy of working capital, the adequacy of reserves, the amount of borrowings, and the earnings for a period of years. Such data can then be modified in the light of estimated future conditions Sometimes, because of sudden shifts in the nature and operation of business enterprises, comparable earnings figures are not available, at least for a long enough period to give perspective.

In lieu of earnings, other criteria must be examined Balance sheet values may serve as one guide, total market value of outstanding securities, if quotations are available, may be another, reproduction cost values may also be helpful

It is essential to realize always that there is no satisfactory single formula for value Value is the result of a judgment based on all the available evidence of figures, appraisals, opinions, plans, and forecasts, and in cases of merger or consolidation the valuation figures of buying and selling groups may be hundreds and thousands, perhaps millions, of dollars apart

Negotiations for mergers proceed in much the same way as "horse trading." The pros and cons are argued and compromises are effected at various stages until there is finally a meeting of minds for completion of the deal Bargaining power is of the first importance in such negotiations The concern in the weaker bargaining position—weaker perhaps because of size, of reputation, or of financial stability—must make the more severe sacrifices or withdraw from the proposed plan.

Growth through acquisition of other properties involves more than valuation There is the further problem of the best means of integration in the particular circumstances Normally one

[1] See Appendix I, "Analysis of Financial Statements," p 345, for a brief explanation of common methods of analyzing financial statements

of three methods will be used—merger, consolidation, or organization of a holding company.

In the case of merger one company absorbs the other, either by purchase of assets or by purchase of stock In the latter case the stock is canceled and the purchased company's corporate entity is discontinued Which of the two methods will be pursued may depend upon legal technicalities, upon whether all of the stock, or at least enough to vote liquidation of the corporate entity, can be obtained, or upon whether or not voting control prior to liquidation will be of value to the amalgamation.

A business consolidation, as usually defined, involves the formation of a new corporation to take over the assets of two or more existing concerns, or to acquire control of their securities and cause them to be liquidated, the assets being left in the hands of the new corporation It is impossible to generalize on the advantages and disadvantages of the merger as compared with the consolidation In each case the question of whether there is particular strength in the goodwill attached to the name of one of the concerns, whether there are technicalities in the way of complete corporate liquidation, and the difficulties in the way of creating a new corporation for the particular purpose must be considered. Sometimes a new consolidation is a compromise resulting from the fact that none of the concerns in the amalgamation is willing to be absorbed by any of the others

The third device is the use of a holding company owning stock in subsidiary corporations Aside from being a device for financing business expansion, the holding company is utilized where it is desired to retain the autonomy and corporate existence of each of the participating concerns Control is obtained simply by the purchase of stock by the holding company. The latter will exercise a greater or lesser degree of management, depending upon its particular objectives and the amount of its ownership in the subsidiary companies concerned

Among the many motives back of mergers, consolidations, and other forms of combinations are the following: (1) the possibility of promoters' profits; (2) the possibility of additional net profit by the merged companies because of economies in production and distribution; (3) the hope of controlling and stabilizing markets, and (4) the personal ambitions of those directly interested in the mergers to exercise greater power through adminis-

tering larger units Of course, not all attempts at combination are successful Promoters' hopes are likely to prove to be too optimistic, expected economies in production and distribution often fail to materialize, it is generally impossible to secure more than a limited control of markets, and all combinations give rise to difficult problems of large-scale management. Furthermore, too little is known today in the way of facts concerning the optimum size of business enterprises and the importance of size factors in economic success

1 LOVETT FLOWERS, INC

VALUATION OF SHARES IN A SMALL FLORIST BUSINESS

In January, 1935, Mr Charles Remington of New York City was considering the sale of his holdings of 75,000 shares of common stock in Lovett Flowers, Inc , a 50% interest, to Mr Lawrence Warner, who already owned 50% of the stock and was willing to buy the remainder at a reasonable figure The problem which confronted the two men at the time was entirely one of appraising the company on the basis of its present position and future prospects Since there were only two stockholders, there was no bench mark of market valuation to follow

Mr John Lovett founded the business in 1910 and developed it into an important unit in the commercial flower industry By 1927 he owned 30 greenhouses well stocked with growing plants, conveniently located in Connecticut near the large New York and Philadelphia markets In the latter year he had established his own wholesale store in New York City, since he found this plan more profitable than dealing with other wholesalers, to whom he had to pay a commission of 10% In 1928 the business was incorporated, with both the greenhouses and the New York store included as part of the assets In the following year, Mr Lovett sold the business to Mr Remington and Mr Warner, each of whom received a 50% interest (75,000 shares)

The new owners attempted to get business outside of the New York and Philadelphia markets, which had formerly absorbed the total flower production of the company In the summer of 1930, in order to enter the Chicago market, they formed Lovett Flowers, Inc , of Chicago, Illinois, and constructed three more greenhouses

The new management left Mr Carter, an experienced grower of unusual ability, in charge of greenhouses, and Mr McCoy, the former owner's assistant, in charge of the New York store For tax reasons this store was set up by the new owners as a wholly owned subsidiary operating under a New York state charter

The new owners also developed a technical research department at this time

By April 30, 1932, the company owned about 47 acres of land valued at $11,267, and some 38 greenhouses The physical property had been well maintained The growing plants were in good condition and the company had an excellent name in the trade

The business was subject both to risks of change in business conditions, because the product is a luxury good, and also to special risks, particularly those of weather. The success of a greenhouse with certain flowers, such as gardenias, depended upon the ability to raise better flowers at the proper time than did competing growers The competitive situation, however, was different in the case of flowers requiring a large amount of time and skill to grow Since the time required for growing some of the perennial flowers in which the company specialized was from six to eight years, a relative scarcity had resulted during the period from 1920 to 1930, because demand had developed faster than the company's ability to grow these perennials High prices, however, encouraged the raising of these flowers, which began to come on the market about 1930, at the same time that demand began to fall off because of the depression This combination of circumstances resulted in much lower prices for the normally high-priced flowers during 1931 and 1932.

The aim of the production department in the greenhouse business was to secure continuous production between Thanksgiving and Easter, with particular attention to the supply of flowers at Christmas and Easter, when demand was the greatest One of the most difficult problems of production was to provide the proper amount of sunshine and the correct temperature to prevent plants from flowering too early or too late The temperature could be quite easily regulated, and the amount of sunshine received could be reduced if the glass of the greenhouse were whitewashed, but there was no way of increasing the amount of light received except by the use of electric light, the cost of which was prohibitive when the lights were used on a large scale

The soil in which the flowers were grown was specially prepared, and had to be discarded every year because of a small insect which infected the roots of the plants, destroying their virility and making them useless for further production The

research department had performed rather successful experiments in eliminating this insect, and if these new methods could be applied commercially, production costs would be materially reduced by the elimination of both the labor of raising new crops annually and the cost of soil Closer control over the time of flowering could also be achieved under this new method, and some of the risks of production minimized

EXHIBIT 1
LOVETT FLOWERS, INC
Consolidated Sales and Earnings*

Fiscal year ending December 31	Sales	Operating profit	Net income	Per share earnings	Per share earnings after adjustment†
1929‡	$1,076,455	$563,169	$500,830	$3 34	$3 87
1930§	818,458	181,555	159,979	1 06	1 59
1931	466,882	105,532	104,586	0 69	1 22
1932	365,931	78,874	79,353	0 53	1 06
1933	498,346	43,821	46,086	0 31	0 84
1934	538,050	55,500	54,000	0 36	0 89
Assuming 11 5 % increase in sales over 1934 levels (estimated)	600,000	130,000	123,000	0 82	1 35
Assuming an improvement in sales to a level better than that of 1931 but not so good as that of 1930	781,500	255,000	243,750	1 62	2 14

* Including 60 %, the proportionate amount of ownership interest, on the sales and profits of the Chicago subsidiary

† Assuming depreciation charges reduced to $25,875 or $ 165 per share and the remaining $77,625 ($0 525 per share) regarded as earnings

‡ Parent company only

§ Includes proportionate interest in Chicago subsidiary's sales and profits for 10 months only

Some types of flowers naturally bloomed from May to October when the commercial demand was low Experiment, however, had developed various hybrid plants that flowered in the winter season at the time when demand was the greatest. Special emphasis had been given by the research department to the development of these hybrids to meet the demand in winter when standard varieties were in small supply

The merchandising of cut flowers had distinct features, because they were very perishable and had to be sold within a relatively short period, and because the demand was predominant on special

occasions, such as weddings and funerals, as well as at Easter and Christmas time. For these reasons wholesale flower prices were very delicately adjusted by supply and demand The demand was relatively inelastic, and small changes in supply affected prices drastically

In attempting to arrive at a reasonable price for the stock of Lovett Flowers, Inc , Mr Remington and Mr. Warner used

EXHIBIT 2
LOVETT FLOWERS, INC
Price-earnings Ratio and Dividend Return for Various Valuations of Earning Assets

A Earnings of $0.89 a share and estimated dividends of $0.75 a share for the current fiscal year ending December 31, 1934

Alternative prices per share	Earnings	Price-earnings ratio	Estimated dividend	Percentage return at estimated dividend and price
$4.50	$0.89	5.1	$0.75	16.7%
6.00	0.89	6.8	0.75	12.5
7.50	0.89	8.5	0.75	10.0
9.00	0.89	10.2	0.75	8.3

B Estimated earnings of $1.35 per share and estimated dividends of $1.20 a share based on 11.5% increase over 1934 sales

Alternative prices per share	Earnings	Price-earnings ratio	Estimated dividend	Percentage return at estimated dividend and price
$4.50	$1.35	3.3	$1.20	26.7%
6.00	1.35	4.5	1.20	20.0
7.50	1.35	5.6	1.20	16.0
9.00	1.35	6.7	1.20	13.3

two different methods the realizable value of the assets of the company per share, and the capitalized earnings per share. In trying to reach a proper net earnings figure, they decided to reduce the amount of depreciation charged from $103,500, or $.69 a share, to $25,875, or $.17 a share, because the former figure included depreciation on growing plants, an item which they felt should not be charged since it would be negligible under good management. As shown in Exhibit 1, earnings figures actually used in valuation were thus $.53 a share higher than reported earnings Computations capitalizing the earnings at various rates are shown in Exhibit 2

EXHIBIT 3
LOVETT FLOWERS, INC
Valuation Based on Assets as of December 31, 1934

	Book value	Estimated current value	
		Total	Per share
Net working capital, parent company	$ 504,000	$ 390,099	$2 60
Stock in Chicago subsidiary	420,000	150,000	1 00
Net fixed assets, parent company	3,214,024	810,000	5 40
	$4,138,024	$1,350,099	$9 00

On the basis of the realizable value of the assets it appeared that the value of the stock was $9 per share, as shown in Exhibit 3 However, that figure did not indicate a conclusive value, because of the impossibility of estimating accurately the value of the stock in the Chicago subsidiary and the realizable value of the company's own fixed assets

Likewise, there was considerable latitude in the estimates of per share value based on capitalized earnings The risky nature of the business suggested a low rate of capitalization, certainly no higher than ten times earnings On the basis of the $0 89 earnings in 1934, before depreciation on growing plants, this would mean a maximum value of $8 90

The figure at which Mr Warner finally agreed to purchase the stock was $7 875 per share

1 Were the methods used in arriving at value sound?

2 What other methods might have been used?

3 If you were Mr Warner, what would you have offered per share for the stock?

2. McHUGH WOOLEN COMPANY

DISPOSITION OF PROPERTIES AND OTHER ASSETS OF A MANUFACTURING CONCERN

Following a series of labor disputes, the principal stockholders of the McHugh Woolen Company, several of whom were directors, decided in December, 1934, to liquidate the company. How to dispose of the properties and other assets, and what price to accept, became primary problems

The McHugh Woolen Company, located in New York State, was established in 1825 and incorporated in 1831. The company manufactured a wide line of men's and women's woolens and worsteds. It purchased its "tops"[1] but performed all other manufacturing operations and had its own dyehouse It had developed its own sales organization and therefore sold directly to large clothing manufacturers and to cutters-up.

The company's earnings were satisfactory until the 1920's, when large losses were incurred. After new management was installed in 1927, however, the company prospered It was the largest manufacturing concern in the community. In 1934, just before the labor difficulties arose, the company was employing about 1,200 men and women, to whom it paid over $22,000 weekly The strike, which lasted five months in 1934, was responsible for heavy losses and for the decision to liquidate the company. The annual net profits of the McHugh Woolen Company for the years ended November 30, 1926 through 1934, were as follows

1926	$502,784[d]	1931	$340,834
1927	*	1932	39,617
1928	85,088	1933	283,104
1929	190,937	1934	375,167[d]
1930	200,238		

* Operations were intermittent, data not available
[d] Deficit

The company's buildings were old, many had been erected before the Civil War They were, however, of strong brick mill-

[1] In wool manufacturing, "tops" are the continuous strands of long fibers which have been straightened and separated from the short ones by combing When drawn and spun, tops become worsted yarn

type construction, and would be adequate for manufacturing for an indefinite period Some of the equipment was antiquated and worn, but some was modern and new. The machinery was in excellent running condition, and with it the company had been able to produce fabrics of outstanding quality and style

The company owned some 50 acres of land on which its operating plant was located, and numerous other parcels of land in the community, such as the 40-acre lot on which the company had laid out a baseball and football field for the use of its employees. The company also owned two entirely separate idle plants, one fairly well equipped for the making of wool tops and the other a vacant cotton spinning mill, and about 20 acres of land In addition the company had title to about 200 acres of woodland, about 100,000 square feet of railroad siding property located in a near-by city, and the water rights of 5 ponds in the vicinity.

The plant and machinery of the company, including the idle machinery at the tops mill and the land and other water-power facilities which have just been mentioned, as well as the so-called water-power developments, such as water-power turbines, wheels, races, and dams, were carried on the financial statement at a gross figure of $1,249,387, as of November 30, 1934 (see Exhibit 1). Depreciation reserves as of this date were $594,680, leaving a net figure of $654,707 on the books for the purpose of reporting to stockholders and banks

In 1933 insurance appraisers estimated that the replacement cost (new) would be $2,500,000 and that reserve for depreciation would amount to $900,000 According to this estimate, the property was worth at that time $1,600,000 In 1930, the town was assessing the property located therein for approximately $1,000,000 The out-of-town property, the woodland acreage, and a considerable part of the water rights were not included in this assessment value Another appraisal, made at the request of the company in 1933 to determine a fair cash value for tax purposes, valued the property in the town at $800,000. In 1934 a firm which specialized in appraising the properties of wool and textile companies valued the land, plant, and machinery at $375,000.

At the time when the question of liquidation arose, the inventory, valued at the lower of cost or market, was carried on the books at over $1,500,000 There was, moreover, a special reserve

EXHIBIT 1
McHUGH WOOLEN COMPANY
Comparative Balance Sheet, as of November 30

	1933			1934		
ASSETS						
Cash		$ 173,023			$ 357,736	
Accounts Receivable, Less Reserves		797,458			321,871	
Inventories at Lower of Cost or Market	$1,691,742			$1,614,551		
Less Reserve	75,000	1,616,742		75,000	1,539,551	
Current Assets			$2,587,223			$2,219,158
Cash Value of Life Insurance Policy and Dividends			20,882			53,118
Deferred Charges			27,152			25,754
Land, Buildings, Machinery, and Equipment at Adjusted Book Value		$1,120,226*			$1,249,387	
Less Reserve for Depreciation		535,087	585,139		594,680	654,707
Total Assets			$3,220,396			$2,952,737
LIABILITIES						
Notes Payable		$ 300,000			$ 700,000	
Pay Roll Drafts Outstanding		14,606				
Accounts Payable		17,517			26,217	
Balance of Contracts for New Machinery and Construction		96,778*				
Accruals		51 618			15,115	
Provision for Taxes		72,407			13,600	
Provision for Cost of Finishing Unshipped Sales		9,242			38,164	
Provision for Dividends Payable		92,565				
Current Liabilities			$ 654,733			$ 793,096

EXHIBIT I (*Continued*)
McHUGH WOOLEN COMPANY
Comparative Balance Sheet, as of November 30

Capital Stock†						
30,855 No-par-value Shares Outstanding			$1,542,750			$1,542,750
Surplus						
Balance, Beginning of Year	$ 946,851				$1,022,913	
Add Discount on 1,420 Shares of Treasury Stock Acquired during Year	8,943	$ 955,794				
Net Profit for Year	$ 283,104			$ 375,167[d]		
Less Dividends Paid and Payable‡	215,985	67,119		30,855	406,022[d]	
Balance, End of Year			1,022,913			616,891
Total Liabilities			$3,220,396			$2,952,737

* Including $74,800 for estimated cost of completing installations and construction in progress

† Number of no-par-value shares

	1933	1934
Authorized	45,000	37,080
Issued	38,775	30,855
In treasury	7,920	
Outstanding	30,855	30,855

‡ Total dividends paid July 15 and Oct 10, 1933, $123,420, Dec 27, 1933, $92,565, and July 16, 1934, $30,855

[d] Deficit

of $75,000 to compensate for any omission in the allowance for costs of processing the goods on hand. Inventory did, however, include a large number of dyed yarns which probably would not be manufactured into men's wear in time for that season's delivery Since color was a major style factor in these yarns, this portion of the inventory was liable to depreciate rapidly

When the decision to liquidate the McHugh Woolen Company became known, various inquiries were made concerning the disposition of the company. In the following months, three groups made definite offers for the property.

The first group was interested in purchasing both the plant and the inventory. After members of this group had spent two or three days at the plant, examining plant records and stock, they offered approximately $1,000,000 for the desirable portions of plant and equipment, and of inventory Selling the property and stock on this basis would have left the company with what would have been for the most part junk, the removal of which would be costly. Negotiations with this group were carried on in December, 1934

Early in 1935 another group asked for permission to inspect and value the plant. Those who made up this group believed that the owners of the McHugh Woolen Company were anxious to liquidate the company and that they would have difficulty in selling it. This group offered $750,000 for the company as it stood

Finally a third group opened negotiations for the purchase of the company This group consisted of representatives of the Carrington Mills, which also manufactured woolen goods At their first conference with the president of the McHugh Woolen Company, they asked him how much the owners expected to get for the company. He stated that, inasmuch as the inventory was worth over $1,500,000, the plant, according to the New York appraisers, $375,000, and the possibility of earnings was large as indicated by past performance, the owners would expect $2,000,000. The president of the McHugh Woolen Company made it clear that the company's name would not be sold, since he believed that it should disappear if the company were transferred to new owners. The company's stock was selling in 1935 in an "over-the-counter" market at $40 to $50 a share.

The prospective buyers said that they would not consider paying so high a price They stated that they were interested only in the inventory and the operating plant, including the water rights They would have no use for the playground, the woodland property, or the buildings in a near-by city They said, furthermore, that they did not intend to use the spinning or the tops mill and that they would prefer not to have all of the operating plant.

Nothing further occurred at that first conference. The president of the McHugh Woolen Company considered that many of the statements made by these representatives were for the purpose of strengthening their bargaining power He believed that they were interested in obtaining the company as a complete operating unit

During the following month, while the president was away, a great many people from all sections of New England and of New York State were making inquiries and inspecting the mill Representatives of the Carrington Mills also communicated with the treasurer of the McHugh company. They were, it seemed, anxious to draw negotiations to a close

The president of the McHugh Woolen Company held a second conference with these representatives shortly after his return They offered at that time $1,200,000 for the part of the company they would buy. They said that the $1,200,000 was being paid for the inventory Although the stock was valued at about $1,550,000, they argued that $350,000 should be considered "insurance" for the inevitable losses due to liquidation. The market for wool, they pointed out, was less favorable than when the inventory had been taken, and the outlook, in view of political conditions, indicated that the market would probably be further depressed They maintained that the physical plant was valueless to them The president of the McHugh Woolen Company conceded $300,000 The two price limits at the close of the conference were $1,700,000 asked and $1,200,000 offered.

Further conferences with prospective buyers were held, but no agreement could be reached regarding a sound basis for the valuation of the company Some of the local properties, however, the playground and two of the tenements which had been occupied by employees of the company, were sold to a syndicate for $45,000, contingent on the sale of the operating plant as a going concern

In the meantime, the officials of the company decided to resume operations in the plant, believing that this move might serve as a real help in bargaining

1 What method should have been used to arrive at a fair valuation of the McHugh Woolen Company properties?

2. What price should the directors have accepted for the company in January, 1935?

3. CRANTON TILE COMPANY

VALUATION AND PURCHASE OF A SMALL INDUSTRIAL COMPANY

In January, 1935, an opportunity to purchase the Cranton Tile Company was presented to Mr Brown, a young man experienced in the tile industry, who was desirous of securing a business to manage and control The company was having difficulty in meeting adverse business conditions, and the owners desired to dispose of the property and free themselves of all personal endorsements on company notes Mr Brown faced the problems of appraising the company, deciding whether or not to buy, and proposing a price for it

The company was established in 1906 in the southern part of New York State. A Mr Reynolds acquired the majority of the stock in 1917 and operated the company profitably until 1929 After his death in 1931, his widow attempted to liquidate her holdings at a satisfactory price but was unable to do so Mrs Reynolds held 432 of the 500 shares of $100-par common stock The three other stockholders were said to be indifferent as to the outcome of the business

Pressure for working capital finally compelled Mrs Reynolds to mortgage her own home and to endorse a Reconstruction Finance Corporation note of $17,000 [1] Annual losses were estimated as follows

1929	$ 8,500	1932	$15,000
1930	23,000	1933	15,000
1931	27,000	1934	Plant not in operation

The company could produce annually 1,000,000 to 1,500,000 square feet of ceramics or floor tile Improvement in the quality of sagger or fire clay would increase the kiln space. After an inspection of the plant, Mr Brown was convinced that the plant could be a low-cost producer, although a small added cost in the production process would be necessary to improve the physical quality of the product The plant itself was modern in construc-

[1] This note, dated Feb 19, 1935, would mature on Feb 19, 1940, bore 5% interest, and was to be amortized at the rate of 20% annually

tion, well supplied with drains, sewers, and water and power outlets. Room for expansion was available

Mr Brown believed that the company's method of distribution was basically sound. Low overhead, favorable freight rates, and flexibility in production would enable the company to meet the price and the service requirements of the jobbers. The product was made in the usual range of sizes and in 24 of the standard colors Extensive research would be necessary to revamp the color line as some competitors had done. New colors and designs were not essential, however, since the company distributed largely through jobbers who catered to users of low-price construction materials.

The company's sales since 1925 were as follows

Year	Sales volume	Feet	Base price, cents	
			Standards	Seconds
1925	$149,791		24	18
1926	161,646		24	18
1927	144,142		24	18
1928	152,988	932,891	24	18
1929	77,847	421,447	21	16
1930	25,334	135,881	18	14
1931	31,153	188,134	16	12
1932	18,855	130,155	14	10
1933	46,538	214,314	24	18
1934	10,561*	42,729	24	22

* Although the plant was not in operation in 1934, income was derived from the sale of inventory

Mr Brown considered that the logical market for this company included New York and six near-by states. The following table shows the sales of the Cranton Tile Company as compared with total sales in these states for 1933 and 1934·

Year	Connecticut New York New Jersey	Pennsylvania Delaware Maryland District of Columbia	Total	Cranton Tile Company	Percentage
1933	$1,330,331	$340,218	$1,670,549	$46,538	2 8
1934	1,636,248	510,989	2,147,237	10,561	0 5

The lack of sales promotion activities by the company made past sales figures an unreliable basis for forecasting future sales Mr Brown felt that his own selling effort should give this company at least 5% of the total logical market. This would have been $83,527 in 1933 and $107,362 in 1934 For the first year under his management, however, he estimated that the sales volume would be $72,000 or $6,000 a month. A leading tile manufacturer concurred in this estimate

EXHIBIT 1
CRANTON TILE COMPANY
Estimate of Expense and Profit for First Year
(Assuming initial processing for 400,000 square feet, to yield 360,000 square feet of finished material)

Gross sales			($0 200)*	$72,000
Direct expense				
Materials	$14,600			
Direct labor, clay preparation	1,600			
Direct labor, pressing	3,600			
Direct labor, kiln	3,600			
Burning, kiln	4,030			
Direct labor, paste, sort and pack	7,600			
Boxes, paste, sort and pack	3,600			
Supplies, etc , sort and pack	720	$39,350	($0 109)*	
Indirect expense†	$ 4,000			
General overhead	12,744			
Administrative expense	6,600			
Traveling and miscellaneous	1,800	$25,144	($0 069)*	
Total expense			($0 178)*	64,494
Net profit (before Federal taxes)			($0 022)*	$ 7,506

* Per sq ft of finished material
† Included in Indirect expense were power and light, steam, filter sacks, die expense, factory maintenance, sagger clay, and sagger making Mr Brown had no accurate basis to arrive at these costs, but he arbitrarily estimated $4,000 a year as a conservative figure

Mr Brown felt that the management called in by Mrs Reynolds had lacked initiative and ability. The manager had not been acquainted with the tile business. He failed to develop effective sales policies. The resulting lack of established goodwill with the trade would prove a difficult obstacle, but Mr. Brown did not regard it as insuperable Mr. Brown expected to devote at least three days a week to calling on the trade in New York, Philadelphia, Washington, and other cities. The remainder of his time would be spent managing the plant. For his services he considered $4,000 a year a fair salary

Mr. Brown drew up a careful budget based on estimated future operations. Exhibits 1, 2, and 3 give his detailed estimates of expense These figures are based on the estimated sales volume of $72,000, which would require production of over 360,000 square feet of tile at the then prevailing price of 20 cents a square foot Assuming a 90% yield, the plant would have to start processing 400,000 square feet of tile a year. If total expense were $64,494, or 18 cents a square foot, a net profit of $7,506 would result (see

EXHIBIT 2
CRANTON TILE COMPANY
Estimate of General Factory Overhead

Factory superintendent at $25 per week	$ 1,300
Factory handy man	832
Workmen's Compensation Insurance	240
General factory insurance on $29,000	186
A D T fire protection	326
Taxes, $3 60 per $100 on $37,500 appraisal	1,350
Factory depreciation, 5% on $72,000	3,600
Interest on factory debt, $25,000 at 6%	1,500
Amortization of factory debt, R F C only	3,400
Total factory overhead	$12,734 a year

Exhibit 1). Mr. Brown estimated, however, that any significant decrease in sales volume or in prices would jeopardize profits. The same result would follow if the selling price changed. Mr Brown believed there should be working capital of at least $5,000 to $8,000 for the first year's operation Assuming a sales volume of $6,000 a month and 30-day credit terms, only $12,000 would be collected at the end of 3 months, $2,676 less than the estimated working capital requirement of $14,676 (see Exhibit 4)

Mr. Brown considered three bases for placing a fair value on the Cranton Tile Company liquidation value, past earnings, and probable earnings He estimated the liquidation value of the company's assets in the following way

Cash to be disregarded in event of liquidation	$
Recorded accounts receivable, as of Mar 7, 1935, 50% of value	1,200
Appraised value of inventories	4,600
Appraised value of land, 60% of	6,000
Buildings valued on replacement basis	20,000
Machinery and equipment	8,000
Total value of assets	$39,800

Subtraction of $28,600 in liabilities (see Exhibit 5) would leave only $11,200 as the net worth of the company. Mr. Brown

realized, however, that Mrs Reynolds would not accept an offer as low as $11,200. Furthermore, because he believed that the company could be operated successfully, he felt that the company was worth more than the liquidation value.

EXHIBIT 3
CRANTON TILE COMPANY
Estimate of Personnel Requirements and Weekly Pay Roll

Department	Men	Women	Weekly pay roll
Clay preparation	2	0	$ 32
Pressing	2	4	72
Kiln	4	0	72
Sagger making	1	0	16
Machinist	1	0	20
Pasting, sorting, packing	2	12	152
Factory handy man	1	0	16
Factory superintendent	1	0	25
Office	0	1	14
Administration	1	0	75
Total	15	17	$494

Since losses had been suffered for the last 5 years, and little information was available for years previous to 1929, Mr Brown could not attempt valuation on the basis of the company's past earnings record The company's future outlook was considered

EXHIBIT 4
CRANTON TILE COMPANY
Estimate of Working Capital Requirements

Pay rolls	$ 494
Materials	280
Indirect expense	75
General overhead	245
Traveling and miscellaneous	35
Total per week	$1,129
Total per month	$4,892

the soundest basis of valuation Mr Brown felt that the government's $4,880,000,000 appropriation for public works would increase the demand for building materials Mr Brown believed that government activities assured the company of a sales volume sufficient to produce the $7,506 profit He recognized, nevertheless, the risks in purchasing the company at a price based on a

capitalization of 10 times, or $75,060, and concluded that such a price would be excessive

Mrs Reynolds asked $43,200 in cash for her shares, one-fourth to be paid immediately and the balance, with interest at 6%, to

EXHIBIT 5
CRANTON TILE COMPANY
Balance Sheets

	December 31, 1934		March 7, 1935	
ASSETS				
Cash		$ 106		$12,000
Accounts Receivable		2,341		2,340
Inventories				
Raw	$1,578		$ 500	
Process	481		200	
Finished	9,538	11,597	3,900	4,600
Fixed Assets				
Machinery and Equipment		21,545		21,545
Land		10,000		10,000
Buildings		37,500		37,500
Total Assets		$83,089		$87,985
LIABILITIES				
Accounts Payable		$ 4,001		$ 3,500
Taxes, 1933 and 1934		2,655		
Tax Penalties		215		
Notes Payable		10,842		25,100
Capital Stock		50,000		50,000
Surplus		15,376		9,385
Total Liabilities		$83,089		$87,985

NOTE Between Dec 31, 1934, and Mar 7, 1935, cash was increased by the R F C loan A rough inspection had shown the inventories to be of little value Taxes and delinquent penalties had been paid Details of Notes Payable follow

$17,000	to the R F C was to mature Feb 19, 1940, it was a first mortgage, five-year loan at 5 %, one-fifth of which was to be amortized yearly
4,500	to Mrs Reynolds, secured by a first mortgage on her home
3,600	to the local bank, secured by the personal bonds of Mrs Reynolds.
$25,100	

be paid over a five-year period. The cash received would retire the major portion of the R F.C loan and thereby relieve Mrs Reynolds of her endorsement The interest paid on the balance would be $5,832, making a total cost to Mr. Brown of $49,032. This he regarded as too high

Mr. Brown offered to manage the company for $50 a week, plus a 5% commission on gross sales. In addition, Mrs. Reynolds

was to give him 50 shares of stock every time one-fifth of the R F C loan was amortized. In this way 250 shares would be transferred in 5 years, unless the loan was retired more quickly. Mr. Brown was then to have the first option to purchase the remaining 182 shares from Mrs Reynolds if she wished to dispose of them. Mrs Reynolds refused to consider this offer, however, mainly because she would not be at once relieved of her R F.C endorsement Furthermore, she would receive no income unless common dividends were paid.

Mr Brown finally concluded that $25,000 would be a reasonable offer for the shares which Mrs Reynolds owned To relieve her of her endorsement he proposed to pay her in cash whatever the R F C required, providing not over $10,000 was necessary The R F C would probably accept the company's unendorsed note for the balance. Mrs Reynolds would receive the balance due her in 4% income notes which would mature in 5 or 6 years She would receive for her stock, then, between $15,000 and $20,000, depending upon the R F C. requirement

Mr Brown was reluctant to advance so much money, but since Mrs Reynolds insisted on freedom from her endorsement, he proposed to secure from his father enough additional cash to make this payment His father, however, believed that although the outlook for the industry was favorable, the risk involved in acquiring this company was too great to warrant such a large payment of cash

1. What basis of valuation should have been used?

2 What proposal, if any, should Mr Brown have made to secure control of the Cranton Tile Company?

4 WALWORTH COMPANY (I)[1,2]

ACQUISITION OF A RELATED BUSINESS

The executives of the Walworth Manufacturing Company believed that the earnings and assets of their company in 1924 justified the completion of the development program conceived in 1916 This program called for the purchase or erection of manufacturing plants in the Chicago district, the Pittsburgh district, the southern district, and the Pacific coast district, and the establishment of wholesale branches in the leading distribution centers of the United States

In 1916 the company had consisted only of the original plant of the Walworth Manufacturing Company which manufactured building and automobile hardware and other metal products. This plant had been erected in Boston, Massachusetts, in 1843, it was the first valve and fitting plant established in the United States. The company manufactured cast and malleable iron pipe fittings, tools, valves, and similar products for the steam fitting and plumbing trades By 1916 it manufactured over 23,000 separate items, all of which it still made in the factory in South Boston With the exception of the wrenches and a small number of other special products which it sold widely throughout the United States and distributed almost exclusively through wholesale channels, the company distributed its products chiefly in New England or shipped them to foreign countries Because of the weight of the leading items manufactured,[3] in comparison to their value, freight rates influenced the distribution of the company's products Purchasers of valves and fittings, moreover, demanded prompt deliveries and special services. With its only plant located in New England and without branch warehouses the company had been unable to compete with those companies

[1] Name changed in October, 1925, from the Walworth Manufacturing Company to the Walworth Company

[2] See Appendix I, "Analysis of Financial Statements," p 353

[3] On the cast-iron fittings and bulky products freight rates frequently amounted to from 10% to 15% of the sales value, on the brass fittings, from 3% to 5%, and on the tools, 2%.

which had plants located in different sections of the United States and which had their own branch warehouses

A careful study of the 23,000 items produced by the Walworth Manufacturing Company in 1916 had shown that 67% of the yearly tonnage consisted of 610 separate items With a national market for its products, the company could manufacture its heavy lines in local plants where there were good labor and material markets, and the large number of other items in special factories Large-scale production of all items would be possible These advantages had convinced the executives that it was a good plan to secure factories in strategic locations

By 1924 the company had purchased plants in the Chicago and southern districts and had established wholesale branches in the leading distribution centers east of the Rocky Mountains It also had established branch warehouses in Seattle, Washington, and in Portland, Oregon Furthermore, the company was at that time completing negotiations for the acquisition of the Mark-Lally Company, a wholesale company with seven branches on the Pacific coast The executives of the Walworth Manufacturing Company believed that on the Pacific coast the demand for their products was not sufficient to justify establishing a factory there In 1924, consequently, the final step necessary for the completion of the company's general development program was the erection or purchase of a plant in the Pittsburgh district. This plant was to manufacture valves, fittings, and other products and to distribute the company's products in the Pittsburgh district and in the southeastern territory which included certain of the southern states east of the Mississippi River.

Three possible ways for the Walworth Manufacturing Company to enter the Pittsburgh district and the southeastern territory were open in 1924:

1 Erecting a factory in or near Pittsburgh and establishing branch houses

2 Purchasing a well-known company manufacturing valves in the Pittsburgh district and establishing branch houses

3 Purchasing the Kelly and Jones Company which had plants near Pittsburgh as well as branch houses.

Because the executives of the Walworth Manufacturing Company believed that there was already adequate production capacity for the manufacture of valves and fittings in the United States they

preferred not to erect new buildings in the Pittsburgh territory if they could purchase an existing factory at a fair price. They were of the opinion, furthermore, that they could purchase a satisfactory plant more cheaply than they could build and equip one. It was decided, therefore, not to consider building a plant or branch houses until investigation proved the impossibility of purchasing already established facilities

The Kelly and Jones Company operated two plants located near Pittsburgh, branch warehouses in Pittsburgh, Chicago, and Cincinnati, and a subsidiary distributing company, the California Steam and Plumbing Supply Company, on the Pacific coast With the exception of drainage and sprinkler fittings and a few other items, the 29,000 products manufactured by this company were also manufactured by the Walworth Manufacturing Company. The Kelly and Jones Company produced about 1,500 tons of finished products each month The Walworth executives were convinced that, with the installation of needed modern equipment and with the expenditure of $200,000 in rearranging the factories, production of the Kelly and Jones Company could be increased to 2,000 tons per month The acquisition of this company would make the Walworth Manufacturing Company the second largest valve and fitting company in the United States

The Kelly and Jones Company had considerable goodwill and was intrenched strongly in the Pittsburgh territory, while the Walworth Manufacturing Company lacked good outlets in that territory. The branch house of the Kelly and Jones Company in Chicago was well located, while the branch house of the Walworth Manufacturing Company was not

From 1919 to 1924 the executives of the Walworth Manufacturing Company had kept in touch with the owners of the Kelly and Jones Company. The executives of the Walworth Manufacturing Company had discussed with the officers of the Kelly and Jones Company their desire to secure a plant in the Pittsburgh district and their interest in the Kelly and Jones Company. Both Mr. Kelly and Mr Jones were over seventy years of age and had no relatives planning to take charge of the business

The Kelly and Jones Company issued no annual financial statement From different remarks made and occasional figures given by Mr. Kelly and Mr Jones in various interviews, the

Walworth executives finally pieced together earning statements, balance sheets, and operating statements as a basis for determining what, in their opinion, the Kelly and Jones Company would be worth. One of the Walworth executives was of the opinion that

EXHIBIT 1
WALWORTH MANUFACTURING COMPANY AND SUBSIDIARIES
Consolidated Balance Sheet, as of June 30, 1925

ASSETS	
Cash	$ 514,761
Drafts and Notes Receivable	192,280
Accounts Receivable, Less Reserve	2,704,147
Inventories (at lower of cost or market)	5,782,762
Prepayments	118,993
Total Current Assets	$ 9,312,943
Investments in Subsidiaries	255,304
Other Investments	84,906
Plant and Equipment, Less Depreciation	4,583,393
Treasury Stock	109,048
Lease-purchase Contracts	42,122
Deferred Charges	270,241
Leaseholds and Goodwill	466,792
Total Assets	$15,124,749
LIABILITIES	
Notes Payable	$ 1,770,000
Accounts Payable	1,113,676
Reserve for Taxes	93,139
Total Current Liabilities	$ 2,976,815
Liability under Purchase Agreement	79,540
Debentures of Subsidiary (not guaranteed by Walworth Manufacturing Company)	218,756
First Mortgage Sinking Fund Gold Bonds	
Series A, 7%, due Jan 1, 1942	2,368,000
Series B, 5%, due Serially 1926 to 1931	600,000
Reserve for Contingencies	661,526
Preferred Stock, 6% Cumulative, Par Value $50	1,000,000
Preferred Stock of Subsidiary, 7% Cumulative, Par Value $100	182,000
Common Stock	4,000,000
Surplus	3,038,112
Total Liabilities	$15,124,749

Condensed from company reports

the capital investment should pay 6% and earn at least 12% He set the 12% figure arbitrarily in the belief that not over one-half of the earnings of a newly formed company should be disbursed as dividends The executives finally estimated that the Kelly and Jones Company would be worth about $7,500,000

They arrived at this figure in the following manner. They estimated that net earnings of the company averaged during a period of seven years about $900,000 annually They decided that this sum should be approximately 12% of the amount to be paid for the company, the price, then, would be $7,500,000 [1] The Kelly and Jones Company had outstanding only 120,000 shares of $25-par-value common stock.

EXHIBIT 2
KELLY AND JONES COMPANY AND SUBSIDIARY
Consolidated Balance Sheet, as of June 30, 1925

ASSETS	
Cash	$ 142,807
U S Liberty Bonds	707,404
Notes Receivable	43,087
Accounts Receivable, Less Reserves	892,417
Inventories (at lower of cost or market)	3,485,329
Prepayments	42,986
Total Current Assets	$5,314,030
Investments	20,355
Plant and Equipment, Less Depreciation	2,737,842
Total Assets	$8,072,227
LIABILITIES	
Accounts Payable	$ 472,836
Reserve for Taxes	24,659
Total Current Liabilities	$ 497,495
Common Stock	3,000,000
Surplus	4,574,732
Total Liabilities	$8,072,227

Condensed from company reports

Early in 1925 the executives of the Walworth Manufacturing Company took definite steps to enter the Pittsburgh territory Accordingly, two representatives visited Pittsburgh to attempt to purchase either the Kelly and Jones Company or some other company. At that time Mr. Kelly and Mr. Jones disclosed their balance sheets and earnings statements The accounts corresponded closely with the statements pieced together by the executives of the Walworth Manufacturing Company The owners of the Kelly and Jones Company asked $9,500,000 for their company They finally scaled this down to a minimum of

[1] The problem of financing expansion has been considered as a separate problem in Walworth Company (II), p 243

$9,000,000, below which they refused to go. The Walworth executives made no definite offer.

The evening after the interview representatives of the Walworth Manufacturing Company carefully studied the detailed balance sheets and earnings statements and agreed that their original estimate of $7,500,000 would be an equitable price. The Walworth executives submitted in writing an offer of $7,500,000 for the Kelly and Jones Company. Mr. Kelly and Mr. Jones

EXHIBIT 3
WALWORTH MANUFACTURING COMPANY AND SUBSIDIARIES
KELLY AND JONES COMPANY AND SUBSIDIARY
Annual Profits after Depreciation but before Interest and Federal Taxes
Years Ended December 31

Year	Walworth Manufacturing Company and subsidiaries	Kelly and Jones Company and subsidiary
1917	$1,901,082	$1,593,475
1918	2,076,754	1,855,372
1919	1,367,652	1,505,046
1920	1,579,345	1,332,690
1921	1,406,579[d]	5,737
1922	1,144,079	443,024
1923	2,337,789	733,056
1924	919,356	181,678
1925*	762,330	191,273
Yearly Average	1,256,683	922,512

* Profits for only the first 6 months are shown
[d] Deficit
Condensed from company reports

studied the offer, decided not to accept it, and informed the Walworth representatives that if this was their best offer, negotiations should be considered at an end

Negotiations were resumed, however, several weeks later The Walworth representatives pointed out that the price they offered for the Kelly and Jones Company's stock, when considered in relation to the company's assets and earnings, compared favorably with the price of leading steel companies' stocks, when considered in relation to their assets and earnings. In an interview on June 9, 1925, a price of $7,800,000 for the Kelly and Jones Company finally was agreed upon with the understanding that, with the exception of dividends at the rate of 12% per annum, all

the earnings of the Kelly and Jones Company during subsequent negotiations should go to the purchasing company The dividends were to be paid to the stockholders of the Kelly and Jones Company. The transfer of ownership finally was concluded on October 26, 1925.

The agreement of sale stipulated that the Walworth Manufacturing Company was to pay $7,800,000 in cash for the assets of the Kelly and Jones Company and was to assume all liabilities with the exception of any contingent liabilities for Federal taxes or special contracts with employees To protect the Walworth Manufacturing Company against such liabilities it was agreed that $300,000 should be placed in escrow by the former owners for a period of years.

One of the first problems considered by the executives of the Walworth Manufacturing Company after concluding negotiations as to the price for the Kelly and Jones Company had been whether they should purchase the assets and assume the liabilities of the company or buy its common stock, which was closely held The latter possibility at first seemed to be the simpler, and it would have permitted the saving of considerable outlay in Federal taxes After further consideration, however, the executives decided to purchase the assets and liabilities of the company, to avoid all appearance of a combination in restraint of trade.

1. Was the merger of these two companies justified?
2. Was $7,800,000 a fair price?
3. Criticize the methods used in determining this price.
4. What factors should the Walworth Company have considered in deciding whether to purchase the common stock or to buy the assets and assume the liabilities of the Kelly and Jones Company?

5. WALWORTH COMPANY (II)[1]

FINANCING THE ACQUISITION OF NEW COMPANIES

The Walworth Manufacturing Company planned in 1925 to change its financial structure, in order to secure funds to purchase the Kelly and Jones Company and the Mark-Lally Company It decided to redeem on January 1, 1926, all its first mortgage bonds and to float two new bond issues as follows

Bonds Outstanding

Series A, 7% First Mortgage Bonds	$ 2,368,000
Series B, 5% First Mortgage Bonds	600,000
	$ 2,968,000

Proposed New Bond Issues

Series A, 6% First Mortgage Bonds	$ 8,500,000
Series A, 6½% Debentures	2,500,000
	$11,000,000

The sinking fund requirements on the new Series A first mortgage bonds were to be 10% of net earnings each year before depreciation, Federal taxes, bond discount, and interest charges on bank loans, but after interest charges on the bonds. The following sinking fund requirements would exist for the Series A Debentures

In the years 1926, 1927, and 1928 (a year)	$100,000
In the years 1929 through 1932, inclusive (a year)	$125,000
In the years 1933, 1934, and 1935 (a year)	$150,000

The Walworth Manufacturing Company planned, further, to change the par value of its present common stock to no par, and to issue 100,000 additional common shares at a price to net the company, after commissions, $18 per share The subscription receipts for 50,000 shares were to be purchased at $18 per share by company executives; 10,000 shares were to be offered to preferred stockholders and 40,000 shares to common stockholders at $20 per share. The preferred stock of the company, amounting to $1,000,000, was to be left outstanding In connection with the issue of debentures, the Walworth Manufacturing Company proposed to issue subscription warrants covering the right to subscribe to 50,000 additional shares of common stock at any time before January 1, 1936, at $30 per share There was a

[1] Refer to Walworth Company (I), p 236, for information regarding the acquisition of the Kelly and Jones Company and description of the Mark-Lally Company

provision that the subscription price be adjusted downward in case the company issued any new common stock at less than $30 per share

Before arranging to issue $8,500,000 of first mortgage and $2,500,000 of debenture bonds, the company considered the feasibility of selling a larger amount of common stock including the proposed 100,000 shares or of issuing Class A and Class B common stock Certain factors favored issuing more stock Fixed charges would be considerably less than if bonds were issued Smaller fixed charges would be particularly desirable in case of declining prices or lessened demand for the products of the Walworth Manufacturing Company. A reasonable degree of flexibility in capital structure was desirable, especially since the volume of business done by firms making valves and fittings was affected to a considerable extent by general business conditions On the other hand, as the executives demonstrated, a large issue of common stock would create the possibility of their losing control of the company. They were convinced that the company could retire the bonds rapidly and that the profits earned then would accrue to the common stock A proposal that the company issue Class A common stock without voting rights and Class B stock with voting rights was rejected, because of the confusion existing concerning the merits of common stock with the non-voting feature

The executives of the Walworth Manufacturing Company decided to issue bonds because they were confident that earnings would be ample and that neither the interest charges nor the sinking fund requirements would prove burdensome in the future. In support of their statement that earnings would be ample they pointed out the following benefits of the consolidation The duplication of executives and sales organizations would be discontinued and all purchasing could be centralized. Manufacturing could be concentrated in the most profitable locations The saving in freight charges alone would be at least $300,000 yearly because the Kelly and Jones Company previously had shipped its products into New England and the Walworth Manufacturing Company had shipped similar products from New England into the Pittsburgh and southeastern territories.

Did the executives adopt an appropriate plan to provide capital for financing the acquisition of the new companies?

6. FIRST NATIONAL STORES, INC [1]

MERGER OF THREE GROCERY CHAINS

Competition in many sections of metropolitan Boston between the grocery stores of The Ginter Company, the John T Connor Company, and O'Keeffe's, Inc, was intense in 1925, in many locations all three companies operated stores in the same block These stores also competed with The Great Atlantic and Pacific Tea Company stores The latter company, which operated the largest chain of grocery stores in the United States, had stores in all parts of the country, while The Ginter Company, John T. Connor Company, and O'Keeffe's, Inc, operated only in New England

In December, 1925, the directors considered merging the three companies It was proposed that The Ginter Company change its name to First National Stores, Inc, and acquire the assets of the John T. Connor Company and O'Keeffe's, Inc, by the exchange of the common and preferred stocks of these companies for securities of First National Stores, Inc. Although the directors were favorable to such a course of action the terms upon which the merger would be consummated had not yet been decided [2]

The executives of the three companies were large stockholders in their respective corporations, and it was expected that they would continue in executive positions in the new company It was desired that the merger be effected without the sale of securities to the public

The Ginter Company was originally founded in 1895 by Messrs Ginter, who then operated two retail grocery stores The company gradually expanded its activities so that in 1925 it operated about 410 retail grocery stores in Massachusetts and

[1] Reprinted from C E Fraser, *Problems in Finance*, 2d rev ed, McGraw-Hill Book Company, Inc, New York, 1930, p 541

[2] "*Merger*," *Compared and Distinguished* "Some courts have noticed a distinction between 'Consolidation' and 'Merger', the former term being used to describe the result of two corporations being combined into a new one, and the latter to describe the result where one corporation absorbs another" (12 Corpus Juris 530)

New Hampshire and 9 restaurants in the city of Boston. The company also operated an administration and distribution warehouse, a bakeshop, candy factory, laundry, stable, printing shop, and garages. It manufactured approximately 9% of the mer-

EXHIBIT 1
BALANCE SHEET OF THREE GROCERY CHAIN STORE COMPANIES

	The Ginter Co , as of Oct 31, 1925	John T Connor Co , as of Oct 31, 1925	O'Keeffe's, Inc , as of Sept 27, 1925
ASSETS			
Cash and Government Bonds	$ 518,967	$ 121,760	$ 509,488
Receivables	41,036	148,172	20,530
Inventories at Lower of Cost or Market	1,739,352	2,276,921	2,064,666
Securities—Miscellaneous	1,500	58,752	
Securities Deposited to Secure Lease	25,550		
Notes Receivable Secured		44,806	
Deferred Charges	67,780	26,232	26,254
Fixed Assets, Less Reserve for Depreciation	1,211,928	423,636	610,646
Goodwill	168,149	250,000	
Sugar Option Deposits		15,898	
Total Assets	$3,774,262	$3,366,177	$3,231,584
LIABILITIES			
Notes Payable	$ 200,000	$ 550,000	$ 322,400
Accounts Payable	481,525	420,777	423,154
Accrued Expenses	74,253		96,820
Miscellaneous Current Liabilities	23,336	187,048	62,355
Reserve for Fire Risk and Taxes	94,214	35,618	
Reserve for Preferred Stock	200,701		
Reserve for Contingencies		997	
Preferred Stock	1,674,470	250,000	1,242,800
Common Stock	175,000	1,500,000	600,105
Surplus	850,763	421,737	483,950
Total Liabilities	$3,774,262	$3,366,177	$3,231,584

chandise sold in its stores. The company leased all its stores, which were located in 93 towns and cities in Massachusetts, 13 in New Hampshire, and 4 in Vermont. The company employed approximately 2,200 people. The company sold only for cash in both its grocery stores and restaurants Exhibit 1 shows the balance sheet of The Ginter Company as of October 31, 1925 As of this date, its capital and surplus were as follows·

Preferred stock, $10 par, 8% cumulative		
Authorized	232,500 shares	$1,674,470
Issued and outstanding	167,447 shares	
Common stock, no-par value		
Authorized	200,000 shares	$ 175,000
Issued and outstanding	150,000 shares	
Surplus		$ 850,763

Exhibit 2 shows sales and net profits over a period of years

EXHIBIT 2
THE GINTER COMPANY
Sales and Net Profits

Years ended Dec 31	Sales	Net profits after all deductions	Number of shares of common stock outstanding at end of fiscal year	Dollar earnings per share after preferred dividends
1919	$ 6,679,489	$343,141		
1920	9,873,221	156,848	17,500	$ 2 55
1921	9,629,315	362,245	17,500	13 18
1922	10,490,523	439,871	17,500	17 57
1923	11,476,859	538,228	17,500	23 18
1924	12,499,381	625,946	150,000	3 28
1925 (10 mos to Oct 31)	11,275,461	530,400		

The John T Connor Company operated a chain of 589 retail grocery stores located in suburban Boston, central and eastern Massachusetts, Rhode Island, eastern Connecticut, and southern Vermont, New Hampshire, and Maine. It also had a large administration and distribution warehouse in Boston. It sold all its groceries for cash only, a large part of them under its own trade-mark, "Brookside" Mr John T. Connor, who founded the business originally in 1900 and incorporated it in Maine in 1901, had retired in 1915 The company leased the properties in which it conducted its business, except for two small parcels of real estate It employed approximately 1,300 people. Its October 31, 1925, balance sheet is shown in Exhibit 1 At this date its capital stock and surplus were as follows:

Preferred stock, $100 par, 7% cumulative		
Authorized	2,500 shares	$ 250,000
Issued and outstanding	2,500 shares	
Common stock, $10 par		
Authorized	150,000 shares	$1,500,000
Issued and outstanding	150,000 shares	
Surplus		$ 421,737

Exhibit 3 shows its sales and net profits over a period of years

EXHIBIT 3
JOHN T CONNOR COMPANY
Sales and Net Profits

Years ended March 31	Sales	Net profits after all deductions	Number of shares of common stock outstanding at end of fiscal year	Dollar earnings per share after preferred dividends
1921	$12,800,506	$ 69,165	90,000	$0 57
1922	10,461,147	349,922	90,000	3 69
1923	12,167,482	428,541	150,000	2 74
1924	15,334,084	511,030	150,000	3 29
1925	15,670,148	322,015		
1925 (7 mos to Oct 31)	9,309,058	186,594		

O'Keeffe's, Inc, operated 640 retail chain grocery stores, 593 of them located in Massachusetts, 45 in New Hampshire, and 1 each in Maine and Rhode Island More than 300 were in metropolitan Boston where a central warehouse and administration building was maintained. The business was started in 1897 with one store In 1910, its 149 stores were incorporated under the name of M. O'Keeffe, Inc In September, 1924, the company absorbed the Cooperative Grocery Stores Company, which had been formed in 1914 to operate stores outside metropolitan Boston, and changed the name to O'Keeffe's, Inc. The new company maintained its own bakery and stable, imported and roasted its own coffee, and manufactured bakery products and flavoring extracts and other articles which comprised about 5% of its total sales It employed approximately 1,500 people and leased all its retail stores Exhibit 1 shows the balance sheet of O'Keeffe's, Inc, as of September 27, 1925 Its capital stock and surplus at this date were as follows·

Preferred stock, $100 par, 8% cumulative		
Authorized	15,000 shares	
Issued and outstanding	12,428 shares	$1,242,800
Common stock, no par		
Authorized	150,000 shares	
Issued and outstanding	149,997 shares	$ 600,105
Surplus		$ 483,950

Exhibit 4 shows sales and net profits of the O'Keeffe companies over a period of years

EXHIBIT 4
SALES AND NET PROFITS OF O'KEEFFE COMPANIES

Years ended April 1	Sales	Net profits after all deductions	Number of shares of common stock outstanding at end of fiscal year	Dollar earnings per share after preferred dividends
		M O'Keeffe, Inc		
1922	$ 5,579,177	$ 90,583	2,750	$32 93
1923	5,895,041	221,558	2,750	80 56
1924	6,427,220	180,385	2,750	65 59
1924 (6 mos to Oct 1)	3,120,011	60,436		
		Cooperative Grocery Stores Company		
1922	$ 7,540,409	$133,999	1,700	$76 97
1923	8,654,068	318,867	3,300	96 62
1924	10,059,935	310,275	6,600	46 54
1924 (6 mos to Oct 1)	5,311,171	147,928		
		O'Keeffe's, Inc		
1925 (6 mos)	$ 9,037,182	$371,757		
1925 (6 mos to Oct 1)	9,211,405	328,158		

The directors of the proposed First National Stores, Inc , were to be selected from among the operating executives and largest stockholders of the three companies It was intended that the three merged companies would continue their stores under the old names with the same merchandise and brands for several years in order to retain the goodwill that had been established It was planned to change the name of these stores as soon as this change could be made without any loss of goodwill and to reduce the number of stores in those sections where the competition with one another was most intense New stores, which would be located so as not to compete with existing stores, would be operated as First National stores

First National Stores, Inc., was to construct a large bakery and warehouse a few miles outside Boston at a central point for the 1,639 stores of the consolidated corporation It was believed that the resulting higher operating efficiency would effect economies that would permit the sale of foodstuffs at lower prices

The company planned to enlarge its facilities so that it could manufacture more of the merchandise sold in its stores. This expansion would enable it to retain profits which otherwise would be gained by outside manufacturers. The large combined business of the three systems was expected to make such manufacturing highly profitable

The common stock of The Ginter Company was listed on the New York Stock Exchange Exhibit 5 shows the quotations during 1925.

EXHIBIT 5
PRICE OF COMMON STOCK OF THE GINTER COMPANY, 1925

Date	Low	High	Date	Low	High
December, 1924	21	25¾	June	34	38⅜
January, 1925			July	37⅞	43⅝
February			August	41⅞	49½
March	24½	28⅞	September	44	47
April	27⅛	30⅛	October	43⅝	48⅛
May	28¾	40⅞	November	44½	49½

This company's $10 par value preferred stock was closely held It was quoted in Boston in September, 1925, at $10 a share The John T Connor Company and O'Keeffe's, Inc , stocks were unlisted In October, 1925, the John T Connor Company common stock was quoted at $29 a share and the latest quotation available on the preferred was $99 a share in September, 1924. No quotations were available on the O'Keeffe's, Inc , stocks

1. Should the three chain store companies have merged?

2. In the event that a merger was formed, what securities of First National Stores, Inc , should have been issued?

3 What amounts of these securities should each of the old companies have received?

7. OUTWATER *et al* *v.* PUBLIC SERVICE CORPORATION OF NEW JERSEY[1]

MERGER OR EXCHANGE OF STOCK IN OTHER CORPORATIONS

. . . . .

BACKES, Vice Chancellor. This bill is to enjoin a merger of five public utility companies into the Public Service Electric & Gas Company The Electric and Gas Company owns more than two-thirds of the capital stock of the merging companies Directors of the Public Service Corporation compose the board of directors of the Electric & Gas Company, members of the latter board form the directorate of four of the merging companies A majority of the board of the fifth company is made up of a director and an officer of the Public Service Corporation and a sympathetic stockholder The plants of the five merging companies are in the possession of the Electric & Gas Company under 900-year leases at net rentals that insure the stockholders of the two lessor companies first named annual dividends of 8 per cent , the next two 5 per cent , and the fifth 4 per cent

The avowed object of the Public Service Corporation, in merging its subordinate companies, is to get rid of the leases . Under the terms of the agreement the stockholders of the companies to be absorbed are to get, in exchange for their shares, 6 per cent , cumulative, preferred stock (nonvoting) of the Electric & Gas Company, redeemable in three years at $110 The basis of exchange is one share of preferred stock, at par, for a share of the stock of the two first named merging companies at a value of $137, the next two at $86, and the fifth at $69. The annual yield on this basis would be slightly in advance of the dividends from the net rentals, viz , on the 8 per cent stock $8 22, on the 5 per cent $5 16, and on the 4 per cent $4 14, and it would appear that the appraisal was influenced by a comparison of annual income, rather than the market value of the stocks, of the merging companies, which were then selling, in a narrow market, at approximately the exchange figures. The complainants, stockholders of four of the merging companies, object to the merger as unfair and inequitable

The attack upon them, that they are actuated in their objection by ulterior motives, finds no justification in the record, surely not as to the Fidelity-Union Trust Company, which, as trustee of the Shanley estate, represents more than 10,000 shares of the merging companies This trustee, an appointee of this court, was ordered to intervene to protect the interest of the estate .

[1] Court of Chancery of New Jersey, 1928 143 A 729

The merger agreement, procedurally, is in legal form, and the right to merge is in entire harmony with the complainants' corporate contract, but, as the merger is, in reality, an appropriation of corporate property by a majority of stockholders, by force of numbers and the grace of the statute, while no valid legal objection can be interposed on that score (*Colgate v U S Leather Co* , 73 N J Eq 72, 67 A 657), the agreement calls for careful judicial scrutiny, and the burden is on the majority to show that the consideration is fair and equitable . . . The decision must rest on the merits, and to that end it has been shown that, when the merger was in contemplation, it was referred by the Public Service officials to responsible bankers to work out a scheme of conversion, and they recommended the alternative offers, and, in respect of the one now the basis of the merger, supported their recommendation at the hearing and stressed the fact that the marketability of the Electric & Gas Company preferred stock gave it a marked advantage The conversion prices, as already stated, were about the average ruling prices in the market at the time for the stocks of the merging companies The market, it is true, was "thin " The stocks were closely held as investments, and there was little activity . .

Now, in addition to fair exchange values, exchange for relative equality of securities in the merged company is implied in all mergers, and relative permanency is a vital element of the securities The five companies were originally leased to the Public Service Corporation and it assigned the leases to the Electric & Gas Company, which in turn assumed the rental obligation With this double undertaking, the payment of dividends on the lessor companies' stock is assured beyond peradventure This security excels in priority all the outstanding obligations of either company. The preferred stock of the Electric & Gas Company, on the other hand, is the next lowest—common stock being lower—security issued by that company, and of this there is now outstanding more than $71,000,000 It is subordinate to outstanding bonds and certificates of indebtedness of more than $82,000,000, and also to debts and liabilities incurred and to be incurred As against these liabilities the corporation has abundant assets, far in excess in value There can be little question of the soundness of the preferred stock at this time The company has made large annual profits, and the future holds promise of continued prosperity Though the possibility of adversity is decidedly remote, such things have come to pass, as, for instance, the New York & New Haven Railroad Company and the Georgia Central Railroad & Banking Company Then the dividends on the preferred stock are payable only if earned, whereas the dividends on the stocks of the complainants' companies are insured in practical perpetuity, underwritten, as they are, by the entire Public Service system

The complainants' resistance and their contention that they ought not to be compelled to exchange their first lien securities for gilt-edged second lien security is not without appeal, and were the decision to rest here, there would be some embarrassment in squaring the merger with fairness But there is a more serious inequity, the preferred stock lacks permanency It is redeemable within three years at the option of the Electric & Gas Company. Thus the merger, in effect, is nothing less than a forced sale by the majority stockholders to itself at a price fixed by it and payable at its pleasure The preferred stock is but the equivalent of a 6 per cent. promissory note payable in three years at the option of the buyer. The merger legislation countenances no such perversion of the contractual obligations of stockholders *inter sese* Continued membership, until dissolution, is an inherent property right in corporate existence A merger is but a fusion of corporate assets and franchises, and an allocation of stock in the merged company, and works a conversion not a destruction of that right In the ordinary case of merging going concerns and the conversion of share for share upon parity of value, all rights, including voting rights, are reserved to stockholders

The redemption feature at $110 offers no adequate compensation, for the complainants would be obliged to reinvest their capital at a correspondingly low rate of return, and besides suffer loss of interest pending reinvestment It is true the complainants would encounter the same disadvantages if their stocks were appraised under the compensation provision of the statute, but that is presently subordinate, for, before the Electric & Gas Company may resort, or the complainants be driven, to that extreme measure, the fairness of the merger must be vindicated (*Colgate v U S Leather Co*, supra), and it would then be available to the Electric & Gas Company only if nonvoting stockholders dissented therefrom, or refused or neglected to convert their stocks The purpose of the statutory grant of eminent domain in this limited form is to perfect, not accomplish, a merger It is not overlooked that under the merger act the merger agreement may provide for "converting the capital stock of each of said merging or consolidating corporations into the stock or *obligations* of such new or consolidated corporation," thus implying that obligations may be given in exchange. Here obligations are not offered, and the question does not directly arise On the contrary, the exchange for preferred stock may later become an obligation of the complainants to take The offer amounts to that However, fairness in mergers dictates that, when obligations are given in exchange for stocks of the character here involved, they at least should bear a corresponding permanent investment value, such, for instance, as the perpetual interest-bearing certificates of the Electric & Gas Company, or like obligations; otherwise, a merger would be a simple medium for a compulsory sale, and that is not permissible.

. . . The complainants' companies are about to be absorbed, and the minority stockholders face the possibility, if not the probability, of being cast into the discard This by right of might and by means unwarranted and oppressive, and their only appeal for relief is to this court The merger will be enjoined .

1. What basis appears to have been used in setting values for the exchange of securities? Do you consider that this would ordinarily be a fair way to determine these values?

2 What light does this case throw on the rights of minority stockholders?

3 What are the comparative advantages and disadvantages of a corporation's expanding by getting majority stock control, by leasing property, and by merging with other companies? Illustrate by reference to the Electric & Gas Company situation.

8 BUCYRUS-ERIE COMPANY[1]

CONSOLIDATION OF TWO STEAM SHOVEL COMPANIES

In August, 1927, the directors of the Erie Steam Shovel Company and the Bucyrus Company, two of the leading steam shovel manufacturers in the United States, contemplated consolidating their companies The Erie Steam Shovel Company had $2,000,000 in common stock and $2,940,000 in preferred stock outstanding, while the Bucyrus Company had $4,000,000 in common stock and $3,900,000 in preferred stock outstanding. A new company called the Bucyrus-Erie Company was to be formed to acquire the stocks of the two companies by issuing its own securities in exchange on some basis yet to be determined

The Erie Steam Shovel Company, founded in 1883, manufactured steam engines exclusively until 1914 when the development of a steam shovel was started In 1920 the company sold its engine department and concentrated its efforts on manufacturing steam shovels. During 1925 and 1926 the company developed under basic patents a gasoline compressed air shovel which was immediately successful Erie shovels were made in two sizes, one having a capacity of five-eighths of a cubic yard and the other a capacity of one cubic yard The gasoline shovel was made in the one-cubic-yard size only By manufacturing only these two sizes, the company had become the leader in this field, it supplied about 50% of all power shovels of a capacity of one cubic yard or less used in the United States Concentration on a few models and quantity production resulted in rapid inventory turnover and low manufacturing costs

The company's plant, located at Erie, Pennsylvania, was well equipped and favorably situated and could increase production 35% without any substantial outlay for expansion Exhibit 1 shows the balance sheets of the Erie Steam Shovel Company as of June 30, 1925, 1926, and 1927. Exhibit 2 shows its income account over a period of years.

[1] Reprinted from C E Fraser, *Problems in Finance*, rev 2d ed , McGraw-Hill Book Company, Inc , New York, 1930, p 562

The Bucyrus Company was organized in 1881. It manufactured excavating machinery of every type: steam, gas, oil, and electric shovels and dredges for mining, for harbor, canal, highway, street, and railroad construction, and for sewer drainage and foundation work. It also manufactured similar equipment, such as railroad wrecking cranes, spreader plows, locomotive pile

EXHIBIT 1
ERIE STEAM SHOVEL COMPANY
Balance Sheet, as of June 30

	1925	1926*	1927
ASSETS			
Land, Buildings, and Equipment (Less Depreciation)	$1,865,992	$1,985,310	$1,941,206
Patents and Goodwill		2,500,000	2,500,000
Marketable Securities	3,024,555		162,196
Cash	1,750,923	1,243,431	2,020,244
Customers' Notes Receivable	} 2,124,621	1,642,676	1,328,602
Customers' Accounts Receivable		548,009	341,880
Inventory at Cost or Market	620,983	720,495	897,954
Other Assets	91,669	96,246	101,558
Deferred Charges	33,953	48,161	62,686
Total Assets	$9,512,696	$8,784,328	$9,356,326
LIABILITIES			
Common Stock†	$3,800,000	$2,000,000	$2,000,000
Preferred Stock, 7% Cumulative	4,940,000	3,000,000	2,940,000
Accounts Payable	234,142	182,375	229,616
Provision for Federal Taxes	246,641	283,628	243,514
Employees' Stock Subscriptions		146,667	117,187
Reserve for Contingencies		100,000	59,272
Capital Surplus	} 291,913	2,266,819	2,265,256
Earned Surplus		804,839	1,501,481
Total Liabilities	$9,512,696	$8,784,328	$9,356,326

* Adjusted to give effect to reorganization and issuance of new capital securities
† Par $100, 1925, $5, 1926, 1927
Condensed from Application of Bucyrus-Erie Company for listing new stock on the New York Stock Exchange

drivers, and ballast plows. The company was the leading manufacturer of large steam shovels in the United States. It had plants in South Milwaukee, Pennsylvania, and in Evansville, Indiana; in 1925 it acquired the Vulcan Steam Shovel Company at Toledo, Ohio. The Bucyrus Company had developed a large sales organization in foreign countries as well as in this country. Exhibit 3 shows its balance sheets for 1924, 1925, and 1926, and Exhibit 4, its income account for the years 1921 through 1926

EXHIBIT 2
ERIE STEAM SHOVEL COMPANY
Consolidated Income and Surplus Account, Years Ended June 30

	1923	1924	1925	1926	1927
Gross sales	$7,221,164	$6,101,163	$5,617,549	$6,584,869	
Gross income after cost of material, labor and manufacturing expenses	3,258,918	2,864,617	2,700,203	2,862,899	
General administrative and selling expenses	827,680	803,518	790,968	828,079	
Operating profit	$2,431,238	$2,061,099	$1,909,235	$2,034,820	$1,870,981
Other income	246,088	115,882	165,674	287,096	168,706
Total profit	$2,677,326	$2,176,981	$2,074,909	$2,321,916	$2,039,687
Depreciation	58,366	64,910	74,732	82,772	133,773
Federal taxes	315,291	258,669	246,641	280,000	243,514
Adjustments	213,960	109,162	150,241	195,832	26,564
Net profits	$2,089,709	$1,744,240	$1,603,295	$1,763,312	$1,635,836
Earnings per share of preferred stock	$69 65	$58 14	$53 44	$58 57	$55 63
Earnings per share of common stock	4 69	3 83	3 48	3 88	3 57

Source Application of Bucyrus-Erie Company for listing new stock on the New York Stock Exchange

EXHIBIT 3
BUCYRUS COMPANY
Balance Sheet, as of December 31

	1924	1925	1926
ASSETS			
Land, Buildings, Machinery, & Patents	$ 7,768,533	$ 8,024,880	$ 8,388,937
Inventories	3,562,550	4,221,023	4,787,947
Accounts and Bills Receivable	2,503,153	2,930,350	2,759,837
Cash	512,059	425,010	501,829
Preferred Stocks Reacquired	250,588	305,621	191,722
Securities	46,035	18,241	13,767
Total Assets	$14,642,918	$15,925,125	$16,644,039
LIABILITIES			
Common Stock	$ 4,000,000	$ 4,000,000	$ 4,000,000
Preferred Stock	4,000,000	3,900,000	3,900,000
Accounts and Bills Payable	744,823	908,286	963,233
Preferred Dividends Payable	310,000	70,000	68,250
Common Dividends Payable		130,000	120,000
Advance Payments	69,768	239,756	260,537
Accrued Taxes and Reserves	635,656	733,782	637,751
Surplus	4,882,671	5,943,301	6,694,268
Total Liabilities	$14,642,918	$15,925,125	$16,644,039

Condensed from Application of Bucyrus-Erie Company for listing new stock on the New York Stock Exchange

The purpose of the consolidation was to bring together under a single management businesses which supplemented each other in the manufacture of excavating machinery The Erie Steam Shovel Company was a leading manufacturer of small steam shovels and the Bucyrus Company was the largest producer of heavy excavating equipment There was practically no overlapping of the types of equipment made The Bucyrus-Erie Company would produce shovels of from one-half-cubic-yard to twelve-cubic-yard capacity. Duplication of equipment and sales

EXHIBIT 4
BUCYRUS COMPANY
Income Account for Years Ended December 31

	1921	1922	1923	1924	1925	1926
Net earnings after taxes	$445,905	$746,301	$1,299,932	$1,489,459	$1,620,630	$1,503,967
Preferred dividends	300,000	420,000	620,000	640,000	280,000	273,000
Common dividends					280,000	480,000
Surplus	$145,905	$326,301	$ 679,932	$ 849,459	$1,060,630	$ 750,967
Earnings per share preferred	$11 15	$18 66	$32 50	$37 24	$40 52	$38 56
Earnings per share common (after preferred retirement reserve)	3 15	10 66	24 49	29 23	33 52	30 77

Compiled from Application of Bucyrus-Erie Company for listing of new stock on the New York Stock Exchange

organization would be eliminated Since large shovels were not sold to the same class of trade as small machines, sales of the two types were not similarly affected in periods of poor business Competition in the sale of large shovels and dredges was not so severe as in that of small shovels The export organization of the Bucyrus Company would be available to the Erie Company It was expected that the establishment of a complete line of excavating machinery would increase the consolidated earnings, would increase manufacturing efficiency by smoothing out the production curve, and would stabilize the sales and earnings of the two companies.

The $100 par value, 7% preferred stock of the Erie Steam Shovel Company was callable at $110 a share It was convertible at par into common stock at $32 a share for the first $1,000,000 offered for conversion, at $36 a share for the second $1,000,000 offered, and at $40 for the third $1,000,000. On June 30, 1927,

there was $2,940,000 of preferred stock outstanding, the balance of $60,000 being in the company's treasury. There were 400,000 shares of $5 par value common stock outstanding. In addition, 84,028 shares of common stock were authorized and reserved by the company for the conversion of the preferred stock. The common stock was on a $2.50-a-share dividend basis. Earnings for 1927 on the common stock were $3.57 a share. On this basis about 70% of earnings was being paid in dividends.

The stockholders of the Bucyrus Company in March, 1927, approved of the increase of the authorized common stock from $5,000,000 to $8,000,000 and of converting it into 320,000 shares of $25 par value. Holders of the outstanding 40,000 shares of $100 par value common stock received four new $25 common shares for each old common share held. The $100 par value, 7% preferred stock was callable at $115 a share and 39,000 shares were outstanding. The new common stock was to receive regular dividends of $3 a year. This was equivalent to $12 a share on the old common stock. Earnings for the year ended December 31, 1926, were $30.77 per share on the old common stock. On this basis about 39% of earnings were being paid in dividends.

Exhibit 5 shows the market values of the preferred and common stocks of the two companies. The Erie Steam Shovel stocks were listed on the New York Stock Exchange, while the Bucyrus Company's stocks were traded in on the New York Curb.

The Erie Steam Shovel Company ended its fiscal year on June 30 and the Bucyrus Company ended its fiscal year December 31. Net earnings of the Erie Steam Shovel Company for the year ended December 31, 1926, for comparison, were $1,955,144. Net earnings of the Bucyrus Company for this period were $1,503,967. The total asset value of the Erie Steam Shovel Company, based on its June 30, 1926, balance sheet, was $9,356,326, including $2,500,000 for patents and goodwill. Total assets of the Bucyrus Company as of December 31, 1926, were $16,644,039.

It was proposed that the Bucyrus-Erie Company issue securities which would be exchanged as follows:

a. One share of $100 par value preferred stock for one share of Erie preferred.

b. One share of $100 par value preferred stock for one share of Bucyrus preferred.

c One share of convertible preference stock of $5 par value for one share of Erie common stock

d Three shares of common stock of $10 par value for one share of Bucyrus common stock

EXHIBIT 5

MARKET VALUE OF THE PREFERRED AND COMMON STOCKS OF THE ERIE STEAM SHOVEL AND THE BUCYRUS COMPANY

Date	Erie Steam Shovel Company				Bucyrus Company			
	Common		Preferred		Common		Preferred	
	Low	High	Low	High	Bid	Asked	Bid	Asked
Jan, 1926					185	195	104	108
Feb					195	205	104	108
Mar					230	240	105	110
Apr					220	230	105	110
May					202	210	105	
June					190	205	105	
July					232	235	105	
Aug					233	237	106	
Sept					223	233	110	
Oct	21½	25½	100	101	230	235	108	
Nov	23¾	25⅝	100⅛	102	220	230	105	110
Dec	23½	25⅛	100½	101½	226	233	109	111
Jan, 1927	24¾	29⅜	101½	107½	232	240	107	
Feb	26⅜	28	104	107	220	230	107	
Mar	25⅞	31¼	106	107½	200	220	105	110
Apr	27½	29⅞	104¾	107¼	205	230	102⅛	105
May	27	29⅞	104½	106	208	220	106	109
June	27	34	105½	108¼	200	202	105	110
July	30⅜	34⅜	108	113⅝	250	265	112	116
Aug	29⅛	31⅞	107¼	109	55½ (New)	56	111	114

When all the stock of both companies was acquired by the new company, its total outstanding capitalization would be not more than 69,000 shares of preferred stock, at least 418,800 shares of convertible preference stock and 480,000 shares of common stock So far as the Erie stockholders exercised their rights to convert preferred into common stock, the amount of new preferred stock would be decreased and the amount of new convertible preference stock would be increased

The preference stock was to be convertible into common stock, share for share, at any time. It was to be noncumulative and was

to receive pro rata dividends with the common stock so that its full dividend of $2 50 was to be paid when the common stock received $1 00 a share It was to rank ahead of the common stock but after the preferred stock, in event of liquidation, and to receive two and one-half times as much in dividends as did the common stock Each share of stock of all classes was to have one vote

Exhibit 6 shows the consolidated balance sheet of the Bucyrus-Erie Company as of December 31, 1926, after giving effect to the proposed exchange of securities

EXHIBIT 6
BUCYRUS-ERIE COMPANY
Consolidated Balance Sheet as of December 31, 1926

ASSETS	
Cash	$ 2,311,073
Receivables	4,330,332
Inventories	5,881,934
Deferred Assets	52,994
Investments	316,989
Land, Buildings, Machinery, and Patents	12,831,641
Total Assets	$25,724,963
LIABILITIES	
Accounts and Notes Payable	$ 1,102,720
Advance Payments Received	260,836
Dividends Payable	188,250
Accrued Items	746,705
Reserves	169,452
Preferred Stock, $100 Par, 7% Cumulative	6,870,000
Common Preference Stock, $5 Par	2,094,000
Common Stock, $10 Par	4,800,000
Capital Surplus	2,345,000
Earned Surplus	7,148,000
Total Liabilities	$25,724,963

Source Application of Erie Steam Shovel Company for listing of new stock on the New York Stock Exchange

1 Should the Erie Steam Shovel Company and the Bucyrus Company have consolidated?

2 Should the proposed plan have been adopted?

9. EASTERN STATES PUBLIC SERVICE COMPANY[1]

PROPOSED FORMATION OF A PUBLIC UTILITY HOLDING COMPANY[2]

The rapid and sustained increase in the market prices of the stocks of public utility holding companies in the summer of 1925 made it apparent that the public was demanding that type of security For this reason, Mr. George Orcutt and Howard Valentine and Sons, Inc , who were associated in the ownership of five electric light, power, and water companies, considered the advisability of forming a holding company for those properties, to be known as the Eastern States Public Service Company, and of selling certain securities of that company to the public

The firm of Howard Valentine and Sons, Inc , was owned by Messrs Joseph and Harvey Valentine Mr Howard Valentine, their father, had died shortly after the company was formed Mr Orcutt had been associated with these men for many years in purchasing small public utility companies to be operated by Howard Valentine and Sons, Inc.

Mr Orcutt and Howard Valentine and Sons, Inc , owned 724 of the Dover Water Company's 800 shares of common stock outstanding and 560 of the Greensborough Water Company's 576 shares outstanding They also held a note of the Dover Water Company for $32,800 The Dover Water Company and the Greensborough Water Company served respectively Dover and Greensborough, which were suburbs of a medium-size city in central New York. The systems of both companies were efficient and large enough to care for the growth of the territories which they served Sales of both the companies had increased steadily since their establishment more than 25 years previously In 1925, the Dover Water Company had 434 customers, and the Greensborough Water Company 798

[1] Reprinted from C E Fraser, *Problems in Finance*, 2d rev ed , McGraw-Hill Book Company, Inc , New York, 1930, p 240

[2] For a discussion of public utility holding companies, see A S Dewing, *The Financial Policy of Corporations*, rev ed , Book IV, chap v

EXHIBIT I

EASTERN STATES PUBLIC SERVICE COMPANY

Consolidated Balance Sheet for the Year Ending June 30, 1925

	Berwick Electric Company	Kendricktown Light and Power Company	Dover Water Company	Greensborough Water Company	Patten Water, Light, and Power Company	Consolidated
ASSETS						
Current Assets						
Cash	$ 47,314	$ 19,002	$ 893	$ 1,387	$ 25,656	$ 94,252
Accounts Receivable	10,588	5,882	1 739	7,590	11,974	37,773
Notes Receivable			1,000		12,205	13,205
Inventory	7,353	2 472	498	1,294	7,384	19,001
Total Current Assets	$ 65,255	$ 27,356	$ 4,130	$ 10,271	$ 57,219	$ 164,231
Fixed Assets						
Plant and Equipment	409,289	110,522	104,624	247,411	295,407	1,167,253
Deferred Assets						
Insurance, Interest, etc	491	2,057	10	868	630	4,056
Unamortized Discount	9,815				15,601	25,416
Total Deferred Assets	$ 10,306	$ 2,057	$ 10	$ 868	$ 16,231	$ 29,472
Total Assets	484,850	139 935	108,764	258,550	368,857	1 360,956
LIABILITIES						
Current Liabilities						
Accounts Payable	$ 1,831	$ 2,426	$ 574	$ 511	$ 4,814	$ 10,156
Notes Payable		53,700	32,800	35,000		121,500
Interest on Bonds	5,346		667	708	1,550	8,271
Consumers' Deposits	1,667	1,265			267	3,199
Accrued Taxes and Expenses	7,357	1,772		1 350	1,200	11,679
Total Current Liabilities	$ 16,201	$ 59,163	$ 34,041	$ 37,569	$ 7,831	$ 154,805
Reserves						
Reserve for Depreciation	67,811	9,022		3,623	74,798	155,254
Reserve for Uncollectible Accounts	797	300				1,097
Total Reserves	$ 68,608	$ 9,322		$ 3,623	$ 74,798	$ 156,351
Capital and Surplus						
Capital Stock—Common	193,000	70,000	80 000	57 600	50,300	450,900
Capital Stock—Preferred				55,400		55,400
First Mortgage Bonds	177,600		65,000	85,000	155,000	482,600
Second Mortgage Bonds			15 000			15,000
Surplus	29,441	1,450	85,277[d]	19,358	80,928	45,900
Total Capital and Surplus	$400,041	$ 71,450	$ 74,723	$217,358	$286 228	$1,049,800
Total Liabilities	$484,850	$139,935	$108,764	$258,550	$368 857	$1,360,956

[d] Deficit

EXHIBIT 2

EASTERN STATES PUBLIC SERVICE COMPANY

Consolidated Income Statement for the Year Ending December 31, 1924, and for Six Months Ending June 30, 1925

	Berwick Electric Company		Kendricktown Light and Power Company		Dover Water Company		Greensborough Water Company		Patten Water, Light, and Power Company		Consolidated	
	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925
Gross revenues												
Commercial lighting	$ 87,655	$45,770	$30,740	$14,881							$118,395	$ 60,651
Street lighting	29,711	15,624	3,154	1,606					$43,242	$21,187	76,107	38,417
Power, etc	261	319	1,294	647							1,555	966
Total gross revenue—Electric	$117,627	$61,713	$35,188	$17,134					$43,242	$21,187	$196,057	$100,034
Meter					$ 3,086	$ 1,772	$18,537	$11,798			$ 21,623	$ 13,570
Flat rate					8,676	4,155	1,652	920	$20,700	$ 9,543	31,028	14,618
Hydrants, sprinklers, etc					2,144	1,044	7,421	4,255			9,565	5,299
Total gross revenue—Water					$13,906	$ 6,971	$27,610	$16,973	$20,700	$ 9,543	$ 62,216	$ 33,487
Total gross earnings (all)	$117,627	$61,713	$35,188	$17,134	$13,906	$ 6 971	$27,610	$16,973	$63,942	$30,730	$258,273	$133,521
Operating expenses												
Production	$ 40,575	$19,957									$ 40,575	$ 19,957
Purchased power			9,724	4,631					$18,845	$ 7,443	28,569	12,074
Transmission and distribution	3,308	2,442	4,428	3,002					1,217	712	8,953	6,156
Commercial	1,597	857	2,121	952					2,430	1,125	6,148	2,934
General and miscellaneous	10,064	5,059	6,253	3,067					7,472	3,472	23,789	11,598
Taxes	9,889	5,091	3,057	1,594					1,959	802	14,905	7,487
Amortization	595	297							360	200	955	497
Total operating expenses—Electric	$ 66,028	$33,703	$25,583	$13,246					$32,283	$13 754	$123 894	$ 60 703

EXHIBIT 2 (*Continued*)

EASTERN STATES PUBLIC SERVICE COMPANY

Consolidated Income Statement for the Year Ending December 31, 1924, and for Six Months Ending June 30, 1925

	Berwick Electric Company		Kendricktown Light and Power Company		Dover Water Company		Greensborough Water Company		Patten Water, Light, and Power Company		Consolidated	
	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925	1924	First Half 1925
Pumping					$ 2,517	$ 1,228	$ 4,616	$ 1,831	$ 2,265	$ 1,067	$ 9,398	$ 4,126
Transmission and distribution					1,139	787	1,181	970	3,092	709	5,412	2,466
Commercial									926	479	926	479
General and miscellaneous					2,359	1,167	5,480	3,034	5,408	2,715	13,247	6,916
Taxes					60	127	2,825	1,600	1,509	705	4,394	2,432
Amortization									360	198	360	198
Total operating expenses—Water					$ 6,075	$ 3,309	$14,102	$ 7,435	$13,560	$ 5,873	$ 33 737	$ 16,617
Total all operating expenses	$ 66,028	$33 703	$25 583	$13 246	$ 6 075	$ 3,309	$14,102	$ 7,435	$45 843	$19,627	$157 631	$ 77,320
Net earnings	$ 51,599	$28,010	$ 9,605	$ 3,888	$ 7,831	$ 3,662	$13,508	$ 9,538	$18,099	$11,103	$100,642	$ 56,201
Fixed charges												
Note interest			$ 2,691	$ 1,437			$ 1,797	$ 946	$ 836		$ 5,324	$ 2,383
Bond interest	$ 10,656	$ 5,328			$ 4,000	$ 2,000	4,250	2,125	7,200	$ 4,170	26 106	13,623
Other interest			15	1							15	1
Dividends							2,972	1,665			2,972	1,665
Total fixed charges	$ 10,656	$ 5,328	$ 2,706	$ 1,438	$ 4,000	$ 2,000	$ 9,019	$ 4,736	$ 8,036	$ 4,170	$ 34,417	$ 17,672
Net income	$ 40,943	$22 682	$ 6 899	$ 2,450	$ 3 831	$ 1,662	$ 4,489	$ 4,802	$10,063	$ 6,933	$ 66,225	$ 38 529
Other income											$ 14 100	$ 7 050
Income available for Eastern States Public Service Company											$ 80,325	$ 45,579

The Patten Water, Light, and Power Company, all of whose 503 shares of common stock were owned by Mr. Orcutt and the Valentine firm, supplied the city of Patten, Massachusetts, and the surrounding country with electricity and sold power at wholesale to two other distributing companies The company owned a dam and a valuable power site on the Wells River, from which it derived power for pumping Patten was the most important city in Wells County, which ranked high among the counties of the United States in agricultural production The company had, in 1925, about 1,000 power and light customers and 480 water customers.

Mr. Orcutt and the Valentine firm owned the 700 shares of common stock outstanding of the Kendricktown Light and Power Company This company served Kendricktown, Maine, a well-known summer resort and a center for the fishing industry on the coast of Maine. In 1925, the company had 999 light customers and 15 power customers.

Mr Orcutt and Howard Valentine and Sons, Inc , owned 1,885 of the Berwick Electric Company's 1,930 shares of outstanding common stock This company supplied power and light to about 5,000 customers in Berwick, Pennsylvania, which had a population of about 8,000 and which was the center of a large agricultural district with a population of from 3,000 to 5,000. There were several manufacturing and canning plants in Berwick.

The total population served by these five companies was approximately 35,000 The five companies together had about 5,000 electric light and power customers and approximately 1,700 water customers. About 75% of the total gross earnings of these companies was derived from the sale of electricity and about 25% from the sale of water. The proposed holding company would neither own nor serve any electric railways

The properties of the Eastern States Public Service Company would continue to be under the management of Howard Valentine and Sons, Inc. This company had managed the properties successfully since acquiring them in conjunction with Mr Orcutt The managing company would receive a fee from each of the subsidiaries of the holding company for its services These fees would be deposited to the credit of the Eastern States Public Service Company and would be available for the bond interest or dividends of that company.

The assets of the Eastern States Public Service Company would consist of the 724 shares of the common stock of the Dover Water Company, the 560 shares of the common stock of the Greensborough Water Company, the 503 shares of the common stock of the Patten Water, Light, and Power Company, the 700 shares of the Kendricktown Light and Power Company, the 1,885 shares of the Berwick Electric Company, and the note of the Dover Water Company for $32,800, all these were owned by Mr Orcutt and the Valentine firm The balance sheets and operating statements of these companies appear in Exhibits 1 and 2

The proposed capitalization of the Eastern States Public Service Company was as follows

	To Be Authorized	To Be Issued upon Formation of the Company
Bonds	$500,000	$500,000
Capital Stock	Shares	Shares
Class A	100,000	20,000
Class B	70,000	60,000

The bonds, which would be secured by stocks of the subsidiary companies, would bear 5% interest and would be due September 1, 1945 The Class A stock would be entitled to preferential dividends of $2 a share per annum payable quarterly on the first day of March, June, September, and December, and cumulative on and after March 1, 1926 This Class A stock would be entitled to $30 a share in event of liquidation and would have priority over the Class B stock as to assets as well as to dividends Class A stock would be subject to redemption and retirement on 30 days' notice at $30 and accrued dividends per share After $2 a share per annum had been paid on the Class B stock, the two classes of stocks would participate equally share for share in any additional dividends which might be paid The voting power would be vested in the Class B stock

1 What is the function of a holding company?

2 What economic justification was there for a holding company in this situation?

3 What are the advantages and disadvantages of a holding company from the standpoint of investors and consumers?

4 Should Mr Orcutt and Howard Valentine and Sons, Inc, have formed the proposed holding company?

5 Below is quoted part of Section 11 from the Public Utility Act of 1935 Would the holding company proposed in this case meet the approval of the Securities and Exchange Commission in its administration of this law?

SIMPLIFICATION OF HOLDING-COMPANY SYSTEMS[1]

Sec 11

b It shall be the duty of the Commission, as soon as practicable after Jan 1, 1938

1. To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system Provided however, That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

A. Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

B All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country, and

C The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation

SUMMARY QUESTIONS

1 What is the true basis of sound valuation?

2 What happens to dissenting stockholders when a merger takes place?

3 What leads to many of the great mergers?

4 Under what conditions would you expect mergers to be generally successful?

5 Is great size, often the result of mergers, a public menace?

6 What weaknesses may develop as a result of mergers and consolidations?

[1] Aug 26, 1935, c 687, Title I, §11

READINGS

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MAY, G O "The Influence of Accountancy on the Development of an Economy," *The Journal of Accountancy*, Vol LXI, No 2, February, 1936, pp 92–105

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VII

RECAPITALIZATION AND REORGANIZATION

From a variety of causes, a corporation's financial situation occasionally may call for partial or complete reorganization of its corporate structure. New funds may be required in order to stave off bankruptcy and destruction When merely a revamping of a company's capital structure is necessary, the process is generally termed "recapitalization," and may be effected successfully, provided most of the various interested groups can be brought into agreement upon a plan of procedure. "Reorganization," on the other hand, is a far more drastic step than recapitalization, and is usually avoided except as a last resort Reorganization ordinarily places the affairs of the company temporarily in the control of the courts This step must be taken to protect the corporation, its creditors, its stockholders, its customers, and the public if its welfare is involved, and is intended to assure equitable treatment of all the parties concerned Otherwise, more aggressive interests might step in ahead of others and liquidate the corporation's resources to the disadvantage of the others. Over a period of years legal means and methods have been developed to cope with the various situations in which the financial affairs of a corporation may become involved

The reorganization of a distressed corporation is primarily a business problem, but is closely connected with the courts Its purpose is to restore the corporation to a position in which it can continue the normal functions of its existence A first step is usually for an interested party in the course of a legal proceeding to petition a court for a receivership The court is asked to provide a legal shelter under which all interested parties may gather during the storm to discuss and to organize a retreat from an untenable position, in order that the assets and business structure may be held together during the period of stress under a management acceptable to the various interested groups. This temporary management, the receiver provided by a decree of the court,

is given practically all the powers of the corporate management and is expected to act for the benefit of all parties concerned The creditors, whether bond or note holders or current creditors, as well as the stockholders, then usually form protective committees to represent their particular interests in subsequent negotiations. Each protective committee appeals for support to members of its own group by requesting the deposit of their securities under so-called deposit agreements

Up to the time when the courts step in to protect all parties, the procedure is relatively simple After that, there may follow a difficult and uncertain period of negotiation, or "horse trading," backed by both logic and emotion, by broad-mindedness and greed Men, not machines, are involved. The actual business problems usually are grave and complicated, requiring an understanding of the basic reasons for the company's difficulties and of methods whereby it may be extricated. Finally, in addition to all these complicating factors, there are the technical legal problems of procedure Certain definite laws, such as the Federal Bankruptcy Act and amendments, exist, and a certain amount of formal legal procedure has developed, specific directions, however, often are lacking or cloaked in vagueness so that much confusion frequently arises. Under these conditions reorganizations may drag along for years, until finally the courts become impatient and force action of some sort It is significant that not infrequently the passage of time with its unforeseeable changes plays a major role in the drama of reorganization.

One of the first questions to be answered by the receivers is should the company be liquidated or should it be rehabilitated? This simple question is basic and in many cases precipitates bitter controversies For example, in the case of a company with some cash, other large assets, relatively small current or bonded indebtedness, and a large stock interest, the chances of paying off all indebtedness completely by liquidation, but perhaps leaving nothing for the stockholders, are substantial Therefore all creditors would probably favor immediate liquidation, because they could anticipate eventually 100 cents on the dollar for their claims, in spite of the fact that the company's bonds prior to receivership may have been selling for only 30 to 50 cents on the dollar. The two sides are quickly drawn and engage at once in violent battle for supremacy under the eyes of the court A plan

of reorganization may be prepared and submitted by the most "exposed" group This is fought over, compromises are made, and finally the plan may be submitted to the security holders and creditors for approval

The law in this country as a rule looks with disfavor upon the destruction of a corporation, even for the interests of the creditors —a fact which has proved to be an important ally for stockholders If a conclusion is reached to liquidate a corporation, assets are converted by sale into cash and distributed to creditors according to proper priority of claims Trustees in bankruptcy, succeeding the receiver but also appointed by the courts, ordinarily carry through the liquidation

Generally, however, some way is found to continue the life of the corporation, particularly if substantial evidence is presented that under new conditions or new management the company may be made profitable. In such cases the two following steps are next given consideration:

1. If new money is needed either immediately for operation or for additional permanent capital, funds must be secured either from existing creditors, from stockholders, or from some new source At this stage an entirely new group sometimes enters the scene, interested in the control of the enterprise For all contributions in the way of new money, new stock or bonds or other financial instruments must be created

2. Creditors of the business may be requested to reduce or to extend their claims, either by accepting new evidence of debts for the old, by reducing the interest on the old debts, by reducing the amount of the old debts, by extending the maturity date of old obligations, or by any combination of these possibilities.

In order to comply with legal requirements, it is often necessary to transfer all a corporation's assets to a new company organized for the purpose. This is carried out by a sale of the property as a whole to the new company.

Many reorganization plans are now being drawn and approved under Section 77B[1] of the Federal Bankruptcy Act. This enact-

[1] Section 77B, added to the often amended bankruptcy act of 1898 in June, 1934, provides a new legal mechanism for reorganizing the capital structure of corporations when they have become insolvent or embarrassed by maturing obligations The new law proposed to reduce losses to debtor companies, creditors, and the public, arising from the awkward process of applying historic foreclosure and sale theory to modern widely held corporations To mitigate these disadvantages Section 77B

ment represents an attempt to give statutory position and definiteness to the procedures worked out in course of time by courts of equity in connection with the receiverships described above

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facilitates adoption of a direct plan for reorganizing the capital structure of a corporation at a minimum of interference with its continuity of operation Either the debtor corporation or creditor groups may petition for reorganization to an appropriate Federal Court which is given jurisdiction over the entire property of the enterprise The court appoints either the management or a trustee, subject to hearing, to conduct the operations of the concern during reorganization The fairness of deposit agreements proposed by interested parties to creditors or shareholders is reviewed When a plan for reorganization has received approval of two-thirds in amount of creditors and a majority in amount of stockholders, its reasonableness is passed upon and the plan becomes operative by court decree Thus there is no foreclosure sale in a superficial market to satisfy dissenting minorities Both assenting and dissenting security holders are bound by the court order, but dissenting holders fare alike with those who did deposit securities in favor of the plan

1 ALLIED STORES CORPORATION

CHANGES IN STOCK PROVISIONS AND SETTLEMENT OF ACCUMULATED DIVIDENDS BY REVISION OF CAPITAL STRUCTURE

In March, 1935, the directors of the Allied Stores Corporation (then Hahn Department Stores, Inc) proposed a plan of recapitalization to clear up the arrearages in preferred stock dividends and on the purchase fund and to reduce future fixed requirements for preferred dividends and for the sinking fund The plan provided for a $3,203,534 issue of 15-year 4½% debentures, and an issue of 22,464 shares of 5% preferred and 1,830,877 shares of common stock

Hahn Department Stores, Inc, was incorporated in May, 1928, to acquire 22 companies operating 27 department stores in 14 states. By the end of 1934, 7 more stores had been added to the group The subsidiaries owned and controlled by the company are listed in Exhibit 1 In every case the unit acquired was either the largest or second largest store in its community The largest single unit in the group was the Jordan Marsh Company of Boston, Massachusetts The stores which merged to become Hahn Department Stores, Inc, in 1928 had combined sales and net income as follows

	1925*	1926*	1927*
Net sales	$109,382,966	$110,374,620	$108,761,318
Net income	6,086,626	6,234,406	6,130,638

* Fiscal year ended Jan 31 of following year
Source Moody's *Industrials.*

Mr Lew Hahn, the president of the new company, pointed out the following advantages of the new organization.[1]

a A stronger merchandising organization available to the individual stores

[1] *Sales Management*, 18 602, June 22, 1929, and 16 724–725, Dec 22, 1928

b. A central buying headquarters and styling service for members of the group

c Closer coordination and supervision.

d Uniform accounting methods

e The possibility of featuring company brands in major lines.

Executives of the holding company were to perform central merchandising and group sales promotion At the time of organization the intention was to expand the chain in the future until sales reached a billion dollars annually

EXHIBIT 1

SUBSIDIARIES OF ALLIED STORES CORPORATION, AS OF MARCH 25, 1935

Jordan Marsh Company	Boston, Massachusetts
C F Hovey Company	Boston, Massachusetts
L S Donaldson Company	Minneapolis, Minnesota
The Bon Marche	Seattle, Washington
The Golden Rule	St Paul, Minnesota
The Rollman & Sons Company	Cincinnati, Ohio
Joske Bros Co	San Antonio, Texas
Herpolsheimer Company	Grand Rapids, Michigan
The Titche-Goettinger Company	Dallas, Texas
O'Neill & Company, Inc	Baltimore, Maryland
Quackenbush Company	Paterson, New Jersey
The A Polsky Company	Akron, Ohio
Smith-Kasson, Inc	Cincinnati, Ohio
The Morehouse-Martens Company	Columbus, Ohio
The James Black Dry Goods Company	Waterloo, Iowa
Rudge & Guenzel Company	Lincoln, Nebraska
Maas Brothers, Inc	Tampa, Florida
The Meyer's Company	Greensboro, North Carolina
The L H Field Company	Jackson, Michigan
F N Joselin Company	Malden, Massachusetts
The Muller Company, Ltd	Lake Charles, Louisiana
Louis Samler, Inc (The Bon Ton)	Lebanon, Pennsylvania
Pomeroy's, Inc	Reading, Pennsylvania
A E Troutman Company	Greensburg, Pennsylvania

Source Annual Report of company for 1935

The company was capitalized with 1,357,489 shares of common stock and 213,569 shares, originally 253,100 shares, of 6½% convertible preferred stock An outline of the stock provisions is given in Exhibit 2. On January 31, 1935, cash of $4,941,174 exceeded current liabilities of $4,721,259 and working capital had increased by $2,337,226 during 1934 to $23,744,475 Book value of the common stock was $6 33 a share [1] Balance sheets for the years 1930 to 1935, inclusive, are presented in Exhibit 3

In March, 1930, *Barron's*[2] commented that centralized management would probably be of ultimate value, although its esti-

[1] Annual Report of company, Jan 31, 1935

[2] *Barron's Financial Weekly*, 10 22, Mar 17, 1930

EXHIBIT 2

ALLIED STORES CORPORATION

(Hahn Department Stores, Inc.)

Summary of Provisions Relating to Capital Stock

Class of stock	Date issued	Dividend rate	Par value	Preference	Provisions for conversion	Provisions for call	Provisions for purchase fund	Voting power
6½ % Preferred	December, 1928	6½ % cumulative	$100	First, as to assets and dividends $110 plus accrued dividends in liquidation	1 share for 2 shares of common	$110 per share on 60 days' notice at any time	3 % annually of the largest amount of 6½ % preferred ever issued and outstanding	Right to elect majority of directors and amend by-laws on default of 4 quarterly dividends
Common	December, 1928, and April, 1935		No par					Exclusive voting power with restrictions noted under preferred
(New) 5 % Preferred	April, 1935	5 % cumulative	$100	First, as to assets and dividends Par plus accrued dividends in liquidation	None	$100 per share, on 60 days' notice at any time	10 % of net earnings annually until retirement of debentures, 25 % thereafter	Right to elect majority of directors and amend by-laws on default of 6 quarterly dividends

Compiled from Moody's *Industrials*

mated cost had been $1,400,000 during the previous year and its benefits would not be realized fully until sales expanded It was stated that the buying offices had a capacity for handling four times the existing sales volume Under the centralized management the company's profits declined from $4,090,061 in 1929[1] to $2,515,844 in 1930,[1] or 38 5%, although sales decreased only $7,326,728, or 6 5%. Deficits were incurred in 1931 and 1932, but an increase in sales volume and a reduction in the expense ratio raised net income to $1,158,723 in 1934 (year ended January 31, 1935), which allowed $5 28 a share on the old preferred stock. Income figures are shown in Exhibit 4 Price ranges on the company's stocks are shown in Exhibit 5

Accumulated dividends of $1,388,200 a year on the preferred stock amounted to $4,858,695 or $22 75 a share on June 30, 1935 The company was $2,235,640 in default on the preferred stock purchase fund,[2] although 23,768 shares of treasury stock could be applied against this at market prices. The total cash necessary to meet the preferred dividend and the stock purchase fund requirements was $2,219,700 annually

The proposed plan of reorganization would substitute an equal number of new 5% preferred for the old 6½% preferred shares The new stock would not be convertible, and the purchase fund would be only 10% of earnings until the new issue of debentures was retired, and 25% thereafter.[3] Voting rights would accrue only when six quarterly dividends were unpaid The call price of $100 would be $10 less than on the old preferred stock. A summary of the provisions relating to the two preferred stock issues is given in Exhibit 2.

Each holder of old preferred stock was to receive in settlement of the accumulated dividends of $22 75 a share, $15 in 15-year debentures, 2 shares of common stock, and $3 in cash If the stated value of $1 a share on the common stock were used, this settlement would be equivalent to only $20 a share The market price of the common stock, however, ranged from just below $4 to just over $5 a share during March, 1935

On adoption of the plan, the directors intended to declare a quarterly preferred dividend of $1 25 on the new preferred stock

[1] Fiscal year ended Jan 31 of following calendar year
[2] Annual Report of company
[3] The old preferred had a fixed purchase fund requirement of $831,500 a year

EXHIBIT 3
ALLIED STORES CORPORATION
(Hahn Department Stores, Inc)
Consolidated Balance Sheet, as of January 31

	1930	1931	1932	1933	1934	1935*	1935†
ASSETS							
Cash	$ 4,357,198	$ 2,585,616	$ 2,789,711	$ 4,240,399	$ 3,054,979	$ 4,941,174	$ 4,300,467
Accounts Receivable	16,431,722	15,845,408	11,900,448	8,894,289	9,788,249	11,295,268	11,295,268
Inventories	14,882,658	13,228,982	11,741,157	8,918,477	10,738,278	12,163,339	12,163,339
Marketable Securities	369,625	47,154	1,764,984	2,023,901	1,511,476	65,953	65,953
Other Current Assets			6,621	6,621	215,240		
Total Current Assets	$36,041,203	$31,707,160	$28,202,921	$24,083,687	$25,308,222	$28,465,734	$27,825,027
Land	10,798,002	12,350,909	11,952,343	11,952,343	11,952,343	14,721,208	14,721,208
Buildings, Fixtures, etc	12,366,191	12,838,774	9,764,762	8,994,032	8,266,447	9,350,651	9,350,651
Goodwill, etc	1	1	1	1	1	1	1
Other Assets	148,375	60,796	281,855	81,504	203,450	198,794	198,794
Insurance Deposits, etc	1,238,826	604,927	388,371	441,744	205,787	216,069	216,069
Restricted Cash					57,555	48,541	48,541
Deferred Charges	983,288	1,077,066	567,607	559,129	708,187	598 155	592,440
Total Assets	$61,575,886	$58 639,633	$51,157,860	$46,112,440	$46,701,992	$53,599,153	$52,952,731
LIABILITIES							
Mortgages, etc, Due		$ 224,500	$ 149,500	$ 137,500	$ 137,500	$ 262,500	$ 262,500
Accounts Payable	$ 7,171,033	5,083,591	3,749,509	2,973,368	2,891,988	3,111,145	3,146,144
Notes Payable	2,847,500					77,424	77,424
Accruals					871,485	1,270,190	1,270,190
Total Current Liabilities	$10,018,533	$ 5,308,091	$ 3,899,009	$ 3,110,868	$ 3,900,973	$ 4,721,259	$ 4,756,258
Unearned Income					92,699	100,815	100,816
Reserve for Contingencies	2,243,654	1,441,016	1,151,114	987,081	987,081	1,264,582	1,264,582
Miscellaneous Reserves			224,190	283,530	121,260	135,108	135,108
4½ % Debentures, Due 1950							3,203,534
Mortgages, Notes	5,615,583	8,325,750	8,201,250	7,863,750	7,726,250	12,376,329	12,376,329
Minority Interest	8,498	1,496					
Preferred Stock	24,236,840	23,126,900	22,086,900	21,546,900	21,356,900	21,356,900	21,356,900
Common Stock	9,869,373	9,869,373	9,869,373	9,869,373	1,357,489	1,357,489	1,784,627
Capital Surplus	} 9,583,405	10,567,007	5,726,024	2,450,938	11,134,596	11,134,596	7,974,577
Earned Surplus					24 744	1,152,075	
Total Liabilities	$61,575,886	$58,639,633	$51,157,860	$46,112,440	$46,701,992	$53,599,153	$52 952,731

* Including Pomeroy's, Inc, and Smith-Kasson, Inc, acquired during 1935 fiscal year
† Pro forma statement giving effect to proposed plan of recapitalization
Source Moody's *Industrials*

Exhibit 4
Allied Stores Corporation
(Hahn Department Stores, Inc)
Consolidated Income Account*

	1929	1930	1931	1932	1933	1934
Net sales (including leased departments)	$112 323,306	$104,996,578	$90,461,797	$70,865,243	$70,828,131	$82,075,720
Net sales (owned departments)		$100,142,301	$85,798,791	$67,032,843	$67,045,151	$77,547,396
Cost of goods sold	$108,684,315†	83,030,057	73,543,908	60,059,398	56,900,112	65,566,225
Gross profit on sales		$ 17,112,244	$12,254,883	$ 6,973,445	$10,145,039	$11,981,171
Income from leased departments		814,419	820,130	689,325	649,544	776,207
Total gross profit		$ 17,926,663	$13,075,013	$ 7,662,770	$10,794,583	$12,757,378
Selling and administrative expense		14,898,814	13,249,201	11,219,551	10,481,895	11,147,327
Net operating profit	$ 3,638 991	$ 3,027,849	$ 174,188[d]	$ 3,556,781[d]	$ 312,688	$ 1,610 051
Other income	853,352	366,323	360 998	309,789	185,329	190 794
Total income	$ 4,492,343	$ 3,394,172	$ 186,810	$ 3,246,992[d]	$ 498,017	$ 1,800,845
Interest	402,282	483,382	451,300	417,552	396,481	460,908
Federal income taxes		296,000				155,000
Other deductions		98,946	44,537	82,711	76,791	26,214
Net income	$ 4,090,061	$ 2,515,844	$ 309,027[d]	$ 3,747,255[d]	$ 24,745	$ 1,158,723
Subsidiary preferred dividends	37,500					31,392
Preferred dividends	1,584,146	1,546,142	1,472,536			
Balance	$ 2,468,415	$ 969,702	$ 1,781,563[d]	$ 3,747,255[d]	$ 24,745	$ 1,127,331
Earned per share, preferred	$16 72	$10 88	Nil	Nil	$0 11	$5 28
Earned per share, common	1 85	0 71	$1 31[d]	$3 79[d]	1 00[d]	0 19[d]
Number of preferred shares	242,368	231,269	220,869	215,469	213,569	213,569
Number of common shares	1,357 488	1,357,489	1,357,489	1,357 489	1,357,489	1,357,489

* Fiscal year ended Jan 31 of following calendar year
† Includes selling and administrative expense, depreciation, and amortization
[d] Deficit
Source Moody's *Industrials*

and to retire the treasury holdings of old preferred stock [1] Debentures in face amount of $3,203,534 were to be issued, bearing interest at 4½%, callable on 60 days' notice at any time, and with an annual sinking fund of 15% of the company's net earnings

From the viewpoint of the holders of the old preferred stock, there were three main advantages to the plan The right to accumulated dividends would be converted in part into a negotiable debenture The holders of the old preferred stock would have an opportunity to share in the company's future growth

EXHIBIT 5
ALLIED STORES CORPORATION
(Hahn Department Stores, Inc)
Price Ranges of Capital Stocks, 1930–1935

Date	6½% Preferred*		Common†		5% Preferred	
	High	Low	High	Low	High	Low
1930	86½	45½	23¼	6½		
1931	63⅞	14	9¾	1¼		
1932	28	7⅛	4¼	⅝		
1933	38½	9	9½	1⅛		
1934	63½	25¼	8¼	3½		
1935 to August 17	73⅝‡	55	7⅜	3⅛	73¾	49

* Offered at $103 in December, 1928, by Lehman Bros and Prince & Whitely
† Offered at $38 in December, 1928, by Lehman Bros and Prince & Whitely
‡ To June 1
Source *New York Times*

because they would receive 24% of the total common stock which would be outstanding The conversion privilege in the old preferred stock, however, also permitted an exchange of one share for two shares of common stock The third advantage would be the immediate settlement of dividends in arrears, and the probability of receiving dividends regularly on the new preferred stock

To the holders of the old preferred stock the disadvantages included the reduction in dividend rate, the reduction in call price, the change in the purchase fund requirement, the elimination of the conversion privilege, the return of voting power to the common stock through settlement of dividend arrears,[2] and the payment of these arrears at a discount, with only part in cash

[1] Letter to Stockholders, Mar 25, 1935

[2] Default of four quarterly dividend payments gave old preferred shareholders the right to elect a majority of the board of directors

Since the accumulated dividends could be paid off only over an extended period of time, however, the payment at a discount might have been regarded as the present value of a claim which would be realized in the future

These disadvantages to the preferred would be favorable factors from the standpoint of the common stockholders Until some settlement was made for the accumulated preferred dividends the common stockholders would not be in a position to receive dividends A change in the purchase fund requirements would also have a favorable effect on the company since it would make it possible for the company to conserve cash resources when earnings were poor Annual earnings applicable to common stock would be increased by $176,200 by the reduction of the dividend rate on preferred stock from 6½% to 5% This was equivalent to a reduction in preferred requirements of from $1,388,200 to $1,212,000 [1] Furthermore, earnings over $1,212,000 would become available for common dividends to the extent of 75% since the sinking fund requirements on the bonds and on the preferred stock totaled 25% The settlement of preferred arrears at a discount meant an increase in the common stock equity

On the other hand, under the new plan the increase in number of common shares from 1,357,489 to 1,784,627 would mean less earnings per share of common stock after total earnings exceeded $1,946,154, as illustrated in the following table

	Before proposed plan	After proposed plan
Total earnings	$1,946,154	$1,946,154
Preferred dividend requirements	1,388,200	1,212,000*
	$ 557,954	$ 734,154
Number of common shares	1,357,489	1,784,627
Earnings per share, common	41 1¢	41 1¢

* Includes $150,165 interest on the 4½ % debentures

Obviously if total earnings were less than $1,946,154, the common stock would earn more per share under the proposed plan than before its adoption

Was the proposed plan of recapitalization fair to all parties and in line with sound financial policies in 1935?

[1] Includes $144,159 interest on 4½% debentures

2 RADIO CORPORATION OF AMERICA (II)

RECAPITALIZATION

On December 27, 1935, Mr Joseph P Kennedy, former chairman of the Securities and Exchange Commission, was retained by the directors of the Radio Corporation of America to devise a plan for the recapitalization of the corporation. His plan, described later in this case, was submitted to the directors on January 23, 1936, and approved by them for submission to stockholders on April 7, 1936.

The Radio Corporation of America was incorporated in Delaware in 1919, as a successor to Marconi Wireless Telegraph Company of America. The General Electric Company, in forming the new company, was influenced not only by its own interest in the radio industry, but by a request from representatives of the United States Navy Department The stated purposes for incorporation were (1) to establish an American owned, operated, and controlled communication company, powerful enough to meet the competition of the radio interests of other nations, and (2) to provide for the construction and operation of radio stations at home and abroad under such terms and conditions as would best serve the government and the American public

The growth of the company was phenomenal Total assets were $35,700,000 in 1921 and total gross income in the same year was $4,161,000 In 1930 total assets were $168,548,000 and total gross income was $137,038,000. Gross income from all sources reached a peak in 1929 of $182,138,000

By 1934 it conducted its operations through wholly owned subsidiaries, as follows: Manufacturing operations were performed by the RCA Manufacturing Company, Inc , together with research, engineering, and sales. In the broadcasting field, the National Broadcasting Company operated two nation-wide networks In the field of communications, Radiomarine Corporation of America handled international business, and RCA Communications, Inc , transmitted domestic inter-city messages Radio

Real Estate Corporation of America served to hold the corporation properties, and RCA Institutes, Inc., furnished training in radio work in two schools, one in New York City and the other in Chicago

The United States Department of Justice instituted a suit against the Radio Corporation of America and associates in May, 1930, under the federal antitrust laws, questioning the legality of the cross license agreements under which they had been and were then operating with the General Electric Company and the Westinghouse Electric and Manufacturing Company Two years before, the Federal Trade Commission after a close examination had dismissed a somewhat similar complaint charging maintenance of a monopoly and unfair competition The corporation contended that the royalty payments made by competitors to the Radio Corporation of America for patent rights were less than they would have been had the patents been more widely held, and that its mobilization of patents had liberated radio art and had made possible the manufacture and sale of 14,000,000 home radio sets within a decade

A consent decree announced to stockholders in November, 1932, by the terms of which Radio Corporation of America became a completely self-contained organization, entirely independent of its early associates and working exclusively through its wholly owned subsidiaries, had a marked effect on the organization and control of the company. The General Electric Company and the Westinghouse company had acquired a controlling interest in Radio Corporation of America through early arrangements and the 1930 agreement Under the consent decree it was provided that the General Electric Company and the Westinghouse Electric and Manufacturing Company should divest themselves within three months, by a ratable distribution to their stockholders, of one-half of their stock in the Radio Corporation of America, and dispose of the other one-half within three years, abstaining from exercising voting rights on the retained stock and giving proxies therefor to an executive committee of Radio Corporation of America.

FINANCIAL HISTORY

The assets of the Marconi Company were purchased by Radio Corporation of America by paying to the stockholders of the

former company $10,000,000 in preferred stock and 2,000,000 shares of common stock The earnings of the Marconi Company for the two years preceding this purchase were reported to have been as follows

1917	$617,773	1918	$711,842

The original capitalization of Radio Corporation of America had consisted of 3,955,974 shares of $5-par preferred stock, cumulative at 7% on and after January 1, 1924, and 5,770,000 shares of no-par common stock

The preferred stock was nonparticipating, but it had equal voting rights with the common stock, and could be retired on any dividend date at $5 50 a share plus accrued dividends.[1] Balance sheets as of December 31, 1920 and 1924, follow

RADIO CORPORATION OF AMERICA
Condensed Balance Sheets, as of December 31

	1920	1924
ASSETS		
Cash and Receivables	$ 881,507	$15,466,740
Inventory	689,516	4,035,433
Investments	3,375,210	4,505,157
Investments in Affiliated Companies	550,385	3,062,656
Plant and Equipment	8,901,675	12,918,009
Deferred Charges	606,670	204,159
Patents and Goodwill	10,107,982	17,785,957
Other Assets		314,240
Total Assets	$25,112,945	$58,292,351
LIABILITIES		
Current Liabilities	$ 1,883,227	$ 8,629,927
Deferred Liabilities		625,000
Preferred Stock	13,525,870	19,779,870
Common Stock	9,611,392	13,767,264
Reserves	92,456	10,489,720
Surplus		5,000,570
Total Liabilities	$25,112,945	$58,292,351

Source Company reports

The capital structure of Radio Corporation of America was changed in 1924 when the 3,955,974 preferred shares were reduced to 395,597 shares having a par value of $50 and classified as Preferred "A" with 10 votes a share The number of common

[1] Exhibit 1 shows in tabular form the stock issues of the company Exhibit 2 gives the important provisions of these issues

shares was also reduced to 1,155,400 and became known as Common "A."

In 1928 the corporation incurred a mortgage debt of $1,320,250 on its New York City office building. This mortgage was increased to over $5,000,000 in 1930 to finance the new RCA Building.

In 1929 the stockholders of Radio Corporation of America approved the acquisition of the outstanding common stock of the Victor Talking Machine Company by the exchange of one share of a new Class "B" preferred stock, one share of common stock, and $5 in cash for each share of Victor common stock. For this purpose there was approved the issuance of 813,365 shares of Class "B" preferred stock having no par value but a redemption value of $100, and a cumulative dividend rate of $5 a year. At the same time, the Class "A" common stock was exchanged for no-par common, 1 for 5, and 810,375 shares more were issued, bringing the total no-par common to 6,580,375 shares.

A further change in the capital structure of the Radio Corporation of America was made in 1930 when the General Electric Company and the Westinghouse Electric and Manufacturing Company sold their stockholdings in Radio Corporation of America subsidiaries to the parent company in exchange for 6,580,375 shares of common stock. This necessitated increasing the authorized number of common shares from 7,500,000 to 15,000,000 and doubling the number of shares outstanding. At the same time the stockholders approved the increase of Class "B" preferred stock from 813,365 to 1,500,000 shares, but the increase was not issued.

Another alteration in the capital set-up of the corporation was effected in 1931 and is shown in the balance sheet for that year, although it was not approved by the stockholders until early in 1932. The stated value of the common stock was reduced from approximately $4.22 to $2 a share, and the surplus thereby created was used to retire 36,100 shares of Class "B" preferred and 30,060 shares of common stock held in the treasury, to reduce the book value of plant and equipment of subsidiaries by $21,733,500, and to increase general reserves by $8,323,900.

The final adjustment occurred in 1932 under the terms of the consent decree. In addition to settling the question of management of the radio industry and most of the problems arising under

EXHIBIT I

RADIO CORPORATION OF AMERICA

Summary of Stock Issued and Outstanding

Class of stock	1919–1923	1924	1929	1930	1931	1932
7% cumulative preferred, $5 par	3,955,974 shares	(changed to 395,597 shares cumulative "A" preferred)				
7% cumulative 'A" preferred, $50 par		395,597 shares	395,597 shares	395,597 shares	395,597 shares	495,597 shares (100,000 shares issued to Rockefeller Center, Inc)
$5 cumulative "B" preferred, no par			803,375 shares	803,375 shares	767,275 shares (36,100 shares retired from surplus after write down of common)	767,275 shares
"A" common		1,155,400 shares (issued to retire no-par common)	(entire issue exchanged for no-par common, 1 for 5)	13,160,750 shares (6,580,375 shares issued to General Electric Radio Co, Inc and West Radio Co, Inc)		
No-par common	5,770,000 shares	(exchanged for "A" common, 5 for 1)	6,580,375 shares (5,770,000 shares for exchange, plus 810,375 shares)		13,130,690 shares (written down from $4 22 to $2 00 a share Surplus retired 30 060 shares)	13,130,690 shares

Compiled from Standard Corporation Records

EXHIBIT 2

RADIO CORPORATION OF AMERICA

Summary of Provisions Relating to Capital Stock

Class of stock	Date of issue	Dividend rate	Par value	Preference	Provisions for conversion	Call price	Voting power
Preferred	1919	7% cumulative	$ 5	first, as to assets and dividends	none	$5 50 per share plus dividends	one vote per share
"A" Preferred	1924	7% cumulative	$50	first, as to assets and dividends	none	$55 per share plus dividends	ten votes per share
"B" Preferred	1929	$5 cumulative	no par	second, as to assets and dividends	none	$100 per share	one vote per share, only after default of four quarterly dividends
"A" Common	1924	payable only after all preferred dividends	no par	none	no preemptive rights to subscribe to additional stock		five votes per share
No-par Common	1919 and 1929		no par	none	no preemptive rights		one vote per share

NOTE All issues are listed on New York Stock Exchange
Source of data Moody s *Industrials*

the patent arrangements, the consent decree provided that the indebtedness of the Radio Corporation of America to the General Electric Company and to the Westinghouse Electric and Manufacturing Company, of $17,938,733, was to be satisfied by the transfer to them of the RCA Building in New York City at its book value of $4,745,000, 10-year debentures in the amount of $4,255,000, and the balance of $8,938,733 by the execution of certain new agreements The debentures were to bear no interest for the first year, from 2% to 5% for the succeeding 4 years, depending upon earnings, and 5% for the remaining years, with redemption after 1934 at the rate of $255,000 each year until the date of maturity Noninterest-bearing notes in the amount of $530,463 were issued at this time also

The consent decree also required the issuance of additional shares of "A" preferred stock. Radio Corporation of America had executed leases for the occupancy of a part of "Radio City" in 1930 These commitments were reduced by the consent decree as to both space and amount of rental under an arrangement whereby Rockefeller Center, Inc, was issued 100,000 shares of "A" preferred stock as compensation for the concession

In addition to organizing a subsidiary company, RCA Photophone, Inc, to develop and distribute sound motion pictures, Radio Corporation of America in 1928 contracted with Radio-Keith-Orpheum Corporation to secure the sale of Photophone equipment to theaters owned or controlled by Radio-Keith-Orpheum Corporation Simultaneously Radio Corporation of America acquired a substantial interest in the Radio-Keith-Orpheum Corporation In 1929 there appeared on the balance sheet a liability of $907,010 Serial Notes Payable, which matured at the rate of $50,000 annually. In 1932 Radio Corporation of America disclosed that the amount of its investment in Radio-Keith-Orpheum was $13,440,229 and that it was committed to pay $2,925,329 for more debentures of that company The debentures were bought in January, 1933 Radio Corporation of America then owned 84% of Radio-Keith-Orpheum's 6% debentures, amounting to $9,786,655, and 64% or 1,647,063½ shares of capital stock, making a total investment of $16,365,558 Radio-Keith-Orpheum went into receivership in 1932 to reduce fixed charges.

INCOME AND DIVIDENDS

Prior to 1924 no dividends had been paid on either preferred or common stock In 1921 the net income of $426,800 (see Exhibit 4) had been applied to amortization of patents The net profit of $2,974,580 in 1922 had been allotted to patents, income tax reserve, and organization expense In 1923 from the net income of $4,737,774 a reserve of $1,384,591 had been set up for the payment of preferred dividends in the following year. Preferred dividends were paid regularly from reserves set up in the previous years until 1926, when they were paid out of current earnings. In the following years the balance of earnings after preferred dividends was applied to organization expense, reserves, patent write-offs, and surplus

The fluctuations of gross and net income from 1921 to 1934 and the operating statement for the years 1929 through 1934, are shown in Exhibit 4 From the second quarter of 1932 until the last quarter of 1933 the corporation did not make a profit In 1933, however, a profit of $1,211,277 was shown in the last quarter, against a loss of $1,793,370 for the first three quarters of that year Although dividends never had been paid on the common stock, dividends were maintained on the preferred "B" stock through the first three quarters of 1931, and on the preferred "A" stock through the first quarter of 1932

The 1933 report of the corporation to its stockholders made the following observation

> . . . although the radio industry is one that has moved rapidly, and one in which new technical developments have rendered old methods and old equipment obsolete, Radio Corporation of America has made the required transition without resorting to public financing.

On February 19, 1935, the corporation paid the accumulated dividends on the preferred "A" stock, but announced that accumulated dividends on the preferred "B" stock could not be paid without seriously impairing working capital No dividends could be declared on the common stock so long as the arrears on the "B" stock were unpaid

PROPOSED RECAPITALIZATION PLAN

The directors and officers of Radio Corporation of America began in 1934 to consider the possibilities of revising the com-

EXHIBIT 3

RADIO CORPORATION OF AMERICA AND SUBSIDIARY COMPANIES

Consolidated Balance Sheet, as of December 31

	1929	1930	1931	1932	1933	1934
ASSETS						
Plant and Equipment	$ 33,086,414	$ 60,375,771	$ 39,379,257	$ 31,164,480	$ 31,977,523	$ 30,662,388
Patents, Rights etc	444,867	3,462,463	4,863,363	5,317,467	8,468,443	8,663,211
Investments in R K O				13,440,229	15,909,126	14,644,614
Investments in Electric and Musical Industries, Ltd	33,032,684	32,279,526	26,760,893	13,189,432	13,189,432	13,189,432
Sundry Investments				5,188,660	3,204,370	3,160,961
Cash	15,318,506	20,379,115	23,916,408	25,555,458	13,149,483	15,073,921
Marketable Securities	16,811,292	903,425	613,458	274,679	7,396,273	8,605,537
Notes and Accounts Receivable (net)	26,732,554	20,898,425	12,591 566	7,971,615	8,233,938	9,162,885
Inventories (net)	31,946,798	28,253,713	8,294,269	4,514,901	6,603,336	8,699,967
Prepaid Taxes, Insurance, etc	1,306,769	1,995,630	641,942	551,118	633,134	677,065
Total Assets	$158,679 884	$168,548,068	$117,061,156	$107,168,039	$108,765,058	$112,539,981
LIABILITIES						
Preferred 'A" Stock	$ 19,779,870	$ 19,779,870	$ 19,779,870	$ 24,779,870	$ 24,779,870	$ 24,779,870
Preferred "B" Stock	17,203,610	72,749,444	16,430,709	16,430,709	16,430,709	16,430,709
Common Stock	15,679,296		26,261,380	26,261,380	26,261,380	26,261,380
Mortgages Payable	1,791,417	5,115,869	3,925,000	3,740,000	3,703,000	3,664,000
Debentures				4,255,000	4,255,000	4,000,000
Notes and Contracts Payable after 1935				530,463	530,463	1,700,463
Notes Payable		5,000,000				
Serial Notes Payable	907,010	857,010	677,650	624,488	654,135	610,338
Accounts Payable	35,097,360	9,592,523	6,585,902	4,651,898	6,765,763	6,913,283
Due to General Electric and Westinghouse	32,000,000	18,182,592	17,729,719			
Dividends Payable	1,309,254	1,304,957	346,005			
General Reserve	2,600,000	4,650,000	9,823,855	12,931,765	12,931,765	12,325,512
Reserve for Federal Income Tax	1,730,971					
Reserve for Special Contingencies	890,852		4,173,277	3,111,282	3,183,883	2,336,072
Deferred Income		1,305,265				
Earned Surplus	29,690,244	30,010,538	11,327,789	9,851,184	9,269,090	13,518,354
Total Liabilities	$158,679,884	$168,548,068	$117,061,156	$107,168,039	$108,765,058	$112,539,981
Current Assets	$ 90,809,150	$ 70,434,678	$ 45,415,701	$38,316,653	$ 35,383,030	$ 41,542,310
Current Liabilities	38,137,585	34,080,072	24,661,626	4,651,898	6,765,763	6,913,283
Working Capital	$ 52,671,565	$ 36,354,606	$ 20,754,075	$ 33,664,755	$ 28,617,267	$ 34,629,027

Sources Moody's *Industrials* and company reports

Exhibit 4
Radio Corporation of America and Subsidiary Companies
Operating Statement, Years Ended December 31

	1929	1930	1931	1932	1933	1934
Gross income (sales, royalties, etc)*	$182,137,739	$137,037,596	$102,645,420	$67,361,143	$62,333,496	$78,756,994
Cost of sales and expenses	159,513 817	122,115,230	91,099,218	62,285,241	58,678,211	69,266,539
Depreciation	2,979,307	6,632,557	7,842,912	4,402,823	3,394,933	3,138,339
Net profit	$ 19,644,615	$ 8,289,809	$ 3,703,290	$ 673,079	$ 260,352	$ 6,352,116
Federal tax reserve	1,743,000	300,000	100,000			805,850
Interest		1,524,321	1,469,181	1,206,665	242,445	502,002
Patent amortization reserve	909,053	939,195	400,000	600,000	600,000	525,000
Amortization of goodwill						270,000
General reserves	1,100,000					
Loss on foreign exchange			965,206			
Net income	$ 15,892,562	$ 5,526,293	$ 768,903	$ 1,133,586(d)	$ 582,093(d)	$ 4,249,264
Preferred "A" dividends	1,373,775	1,373,300	1,373,907	343,019		
Preferred "B" dividends	3,037,500	3,832,700	2,876,972			
Subsidiary dividends	1,094,435					
Common dividends						
Surplus for year	$ 10,386,852	$ 320,293	$ 3,481,976(d)	$ 1,476,605(d)	$ 582,093(d)	$ 4,249,264
Earned per share "A"	$40 17	$13 97	$1 94	Nil	Nil	$8 57
Earned per share "B"	18 07	5 17	Nil	Nil	Nil	3 28
Earned per share Common	1 58	0 02	0 34(d)	0 51(d)	0 47(d)	0 11(d)

* Radio Corporation of America Gross and Net Income, 1921 through 1928

	1921	1922	1923	1924	1925	1926	1927	1928
Gross income	$4,160,845	$14,830,857	$26,394,790	$54,848,132	$50,405,144	$60,437,462	$65,082,074	$101,851,603
Net income	426,800	2,974,580	4,737,774	9,503,442	5,737,206	7,367,100	8,478,320	19,834,799

(d) Deficit
Sources Moody's *Industrials* and company reports

pany's capital structure In December, 1935, Mr Joseph P Kennedy was retained to devise a plan for the recapitalization of the company The plan which he offered was as follows [1]

1 The borrowing of $10,000,000 from seven banks at 2½ per cent annual interest for five years, repayable in whole or in part at any time prior to maturity, in order to maintain working capital at an appropriate ratio to business turnover

2 The retirement of all the outstanding Class A preferred stock for cash at the callable price of $55 a share, requiring $27,257,835, and accrued dividends

3 The exchange of each share of Class B preferred stock, including all accrued dividends at present amounting to $21 66 a share, for a block of securities consisting of one and one-fifth new first preferred shares and one common share

The new first preferred stock will be callable at $100 a share and accrued dividends, will be entitled to cumulative annual dividends of $3 50 a share from April 1, 1936, and will be convertible into five shares of common stock for each share for five years, unless sooner redeemed Each new preferred share will be entitled to one vote

Radio Corporation common stock closed at 12⅞ on the New York Stock Exchange yesterday and the Class B preferred stock at 95, after reaching a new high price of 97 On the basis of the conversion privilege of the proposed new first preferred stock and the exchange outlined for present Class B preferred stock, the holder of each present Class B preferred stock share ultimately would obtain seven common shares through the exchange and conversion proposed, or 97⅛ at present market levels

. .

While the $33,000,000 cash on hand of the corporation would be sufficient to carry out the plan, $18,000,000 of this amount has been earmarked by the directors as working capital, on the basis that $1 in cash is required for each $5 of annual revenue Retirement of the Class A preferred and the borrowing of $10,000,000 would leave the corporation with $16,000,000 in cash, which will be supplemented by accruals to cash position this year from earnings

The company last year sold one-half of its Radio-Keith-Orpheum investment and granted an option on the balance which runs to the end of 1937 Exercise of this option would add some $5,000,000 to cash resources

No underwriting will be necessary to carry out the plan

Mr Sarnoff yesterday made public a preliminary earnings statement for 1935 showing net income of $5,100,000 after all deductions compared with $4,249,264 in 1934

[1] Reprinted from *The New York Times*, Feb 1, 1936

Net earnings after costs and expenses were $10,254,267, against $9,490,455 Fixed charges were $110,824 lower at $391,178 and depreciation $175,850 lower at $2,961,489 Amortization of patents was $75,000 higher at $600,000 and of goodwill $40,000 higher at $310,000, while Federal income tax was $84,750 higher at $890,600

While on the present capital basis, the 1935 net income is equal to about $4 35 on 767,275 Class B preferred shares after Class A preferred dividends On the reorganization basis the earnings would be equivalent to 11 7 cents a share on the 13,897,963 common shares.

Based on 1935 earnings and upon conversion of all the new first preferred stock into common stock, net income would be equivalent to 25 7 cents a share on the 18,501,616 ultimate number of common shares The computations allow for fixed charges as actually reported in 1935 and for $250,000 additional interest on bank loans Actually, fixed charges will be $222,000 annually before interest on bank loans

The new first preferred stock will rank ahead of any Class B preferred stock not exchanged under the plan Each holder of B preferred stock who accepts the plan will begin to receive dividends totaling $4 20 a year immediately upon consummation of the plan, or $3 50 on each full share and 70 cents additional on each one-fifth share received, before any dividends will accrue on unexchanged B preferred shares

A letter to be mailed next week to stockholders recommends deposits of the B preferred stock under the plan and announces a special meeting on April 7 to act on the plan An amendment to the certificate of incorporation of the company will be required to carry out the plan, assent of a majority of each class of stock entitled to vote being required to secure its adoption

The board will not declare the plan operative unless the deposited Class B preferred stock is sufficient, in the judgment of directors, to justify its consummation

Mr Kennedy said he felt that the proposal recognizes the respective rights of each class of stockholders and is advantageous to all of them and to the corporation

He explained other alternatives proposed at various times and felt particularly that a "reverse-split" which would multiply the value of present common shares would be detrimental to common stockholders

He felt that it was imperative that the directors take advantage of the low-money market conditions by retiring the 7 per cent preferred stock by using cash realized from sale of certain capital assets and of money borrowed at a cost of only 2½ per cent

On the other hand, he said it would be clearly impossible to pay in cash out of earnings now or in the near future, the $17,263,690 dividend arrears on the Class B preferred stock, calculated to April 1, next There was every reason to expect dividends of $3 50 a share could be maintained on the new first preferred stock, he added

Of particular interest to common stockholders he found was the annual net saving in charges ahead of the common stock of $2,098,400, assuming exchange of the B preferred stock, retirement of the A pre-

ferred stock and interest on bank loans, together with elimination of arrears on the B preferred stock

In exchange for these benefits, common stockholders will be asked to approve an increase of less than 6 per cent in number of shares outstanding at the outset and an additional increase of 35 per cent upon conversion of all the first preferred stock, which would eliminate an issue with a charge upon assets of $92,073,012 and an annual charge upon earnings of $2,222,600, both ranking ahead of common stock.

The changes in capitalization entailed under the plan follow

(Last three figures omitted)

	Present status	Status after exchanges	Status after conversions
Notes and mortgages	$ 4,701	$ 4,701	$ 4,701
Bank loans		$10,000	$10,000
A preferred*	$27,257		
B preferred*	$76,727		
A and B preferred arrears	$17,263		
Common (shares)	13,130	13,897	18,501
Quick assets	$33,470	$16,213	$16,213

* Based on call prices

Annual charges ahead of common stock, based on the above stages, follow:

(Last three figures omitted)

	Present status	Status after exchanges	Status after conversion
Notes and mortgages	$ 222	$ 222	$222
Bank loans		250	250
A preferred dividends	1,734		
B preferred dividends	3,836		
$3 50 preferred dividends		3,222	

. .

1 Why did the question of revising the company's capital structure arise?

2 What parties were interested in the recapitalization of this company? What were their rights?

3 Should Mr Kennedy's plan of recapitalization have been approved? Did it treat all groups equitably?

3. BLOOMINGTON COMPANY

PLAN OF RECAPITALIZATION

The directors of the Bloomington Company, realizing that their company was overcapitalized, considered in 1933 several plans of recapitalization which would provide a less complicated capital structure and be more in line with earnings

The Bloomington Company, located in Ohio, had been engaged for over 65 years in the manufacture of steel products. It was especially equipped to manufacture light rails and plates for electric and steam railroads and mining companies. For a long period the company had paid interest regularly on its funded debt Earnings in profitable years had provided sufficient funds to meet payments in less profitable periods General business conditions caused wide variations in the company's earnings, however, so that a simpler capital structure and one with less fixed charges was desirable.

Any plan of recapitalization would have to be acceptable to all those who held securities in the company. No group could force the company to reorganize, because the company had met all important obligations. There was in 1933 no possibility of the company's raising funds sufficient to redeem its existing indebtedness.

In 1933 when plans for recapitalization were being proposed, balance sheet items were as shown in Exhibit 1. The following securities were outstanding·

First mortgage sinking fund 6% gold bonds due in 1945	$ 400,000
7% debentures, series "A," due in 1949	$1,550,000
7% cumulative preferred stock, par $100	22,500 shares
Common stock, without par value	19,000 shares

Sinking fund payments on the first mortgage bonds and on the debentures had been suspended until 1936. No dividends had been paid on the common or on the preferred stock since 1921. The accumulated dividends on the preferred stock amounted to $77 a share The company's earnings for the years 1929 through 1933 are shown in Exhibit 2.

EXHIBIT 1
BLOOMINGTON COMPANY
Balance Sheet, as of December 31

	1929	1930	1931	1932	1933
ASSETS					
Cash	$ 279,133	$ 483,600	$ 258,840	$ 178,900	$ 315,860
Accounts and Notes Receivable	957,504	632,880	332,350	338,650	315,720
Inventories	1,559,858	1,061,400	661,280	476,550	537,000
U S Government Securities			358,800	373,200	357,700
Total Current Assets	$2,796,495	$2,177,880	$1,611,270	$1,367,300	$1,526,280
Deferred Charges	185,184	156,350	140,280	133,150	116,800
Investments	7,921	4,800	93,120	102,950	128,040
Other Receivables	285,902	301,320	317,300		
Other Assets		76,930	1,700	1,000	44,000
Real Estate, Plant, etc, Less Reserves	4,637,633	4,724,880	4,467,400	4,257,700	3,997,080
Total Assets	$7,913,135	$7,442,160	$6,631,070	$5,862,100	$5,812,200
LIABILITIES					
Accounts and Notes Payable	$ 502,693	$ 294,420	$ 136,000	$ 65,000	$ 99,000
Accruals	79,048	74,720	66,350	66,160	96,800
Total Current Liabilities	$ 581,741	$ 369,140	$ 202,350	$ 131,160	$ 195,800
Mortgage	166,000	166,000	166,000	166,000	166,000
Reserve for Contingencies		173,000	312,000	34,940	72,500
Funded Debt	2,349,000	2,214,000	1,952,000	1,950,000	1,950,000
Preferred Stock	2,250,000	2,250,000	2,250,000	2,250,000	2,250,000
Common Stock	1,900,000	1,900,000	1,900,000	1,900,000	1,900,000
Surplus	666,394	370,020	151,280[d]	570,000[d]	722,100[d]
Total Liabilities	$7,913,135	$7,442,160	$6,631,070	$5,862,100	$5,812,200

[d] Deficit.

EXHIBIT 2
BLOOMINGTON COMPANY
Income Statement, Years Ended December 31

	1929	1930	1931	1932	1933
Operating profit	$848,537	$334,320	$ 12,000	$ 21,960L*	$283,680
Depreciation	273,647	270,000	270,720	255,360	253,030
Operating profit after depreciation	$574,890	$ 64,320	$258,720L	$277,320L	$ 30,650
Other income		1,800	21,840	18,840	42,960
Total income	$574,890	$ 66,120	$236,880L	$258,480L	$ 73,610
Less Interest and miscellaneous expenses	203,015	213,480	145,440	157,560	188,520
Net loss†	$371,875‡	$147,360	$382,320	$416,040	$114,910

* L Loss
† Before deducting appropriations for reserve for contingencies
‡ Profit

Of the company's securities the public held but a relatively small amount, employees held some, but most of the stocks and bonds were held by the managers and directors of the company. One large interest held only common stock, one other interest held common and preferred stock, but all the other important interests held some of each type of the company's securities

The directors all agreed that the 6% mortgage bonds should remain undisturbed under any plan of recapitalization Interest was earned on these bonds, and the assets of the company were more than sufficient to cover them

Several of the directors who were representatives of the investment houses that had originally underwritten the 7% debentures insisted that the company really belonged to the bondholders Since the bondholders were unable to obtain control, however, unless interest on their bonds were defaulted, they were anxious to have some plan of recapitalization adopted to guard against any dissipation of the company's assets

The preferred stockholders argued that there was some equity left for them. They wanted, in addition, some settlement for accumulated dividends, but realized that the possibility of securing such a settlement was unlikely Since both the common stock and the preferred stock entitled holders to one vote per share, voting control was really in the hands of the preferred stockholders This preferred stock had been paid for originally in cash at $100 per share

Mr George, who had been a director of the Bloomington Company and who represented 35% of the common stock interests, argued that the common stockholders should be included in any plan of recapitalization He maintained that since the company did not need additional cash, there was no reason why the common stockholders should contribute funds They had paid, he said, $60 a share for the common stock and had received no return on their investment since 1921 He contended that although they had no apparent equity at that time they were, nevertheless, owners of a going concern He made it clear that the common stockholders were in a position either to aid or to hinder recapitalization

The preferred stockholders favored Plan I and urged its adoption even though Mr George's critical attitude toward it was known. The details of this plan were as follows

1 *First Mortgage Bonds*—The $400,000 issue of first mortgage sinking fund 6% gold bonds, due in 1945, was to remain undisturbed.

2. *Debentures*—The 7% debentures, series "A," due in 1949, outstanding in the amount of $1,550,000 were to be exchanged for a like amount of collateral lien 7% income debentures, maturing July 1, 1958, and were to be secured by the deposit of the debentures which would be turned in for exchange Interest on the new income debentures was to be payable to the extent earned in any one year, provided that the earned interest payment in any year might be deferred, in whole or in part, at the discretion of the board of directors, when the payment of interest would impair the cash position of the company Interest at the designated rate was to be cumulative from July 1, 1936, whether or not earned The sinking fund was to equal one-third of the earned depreciation in any year and, in addition, one-third of the excess earnings after all charges for interest, for the sinking fund under the First Mortgage and under the income bonds The company was to have an option to make additional payments to the sinking fund, to be credited on future installments The company was to have the right, furthermore, to make payment into the sinking fund in income debentures, at par, to the extent not so paid, the company could use cash for the purchase of bonds in the open market at the lowest offering

Holders of the debentures exchanged were to receive also ten shares of new Class B stock (see Note) for each $1,000 face amount exchanged

3 *Preferred Stock*—The 22,500 shares of existing 7% cumulative preferred stock (dividends in arrears from September 30, 1921) were to be exchanged share for share for new Class A stock of no-par value, preferred to the extent of $100 per share, on dissolution or liquidation, bearing 6% noncumulative preferential dividends, callable at 105, carrying preemptive rights and voting power Stated capital on books would be at, say, $75 per share.

Holders of the preferred stock were also to receive three shares of Class B stock (see Note) for each share of preferred held

4 *Common Stock*—The 19,000 shares of existing common stock of no-par value were to be exchanged share for share for new Class B stock without par value Stated capital on the books would be, say, $2 50 per share The Class B stock would be entitled to preemptive rights and voting power.

NOTE: 1 No dividends were to be paid on either class of stock while the income bonds were in default in any particular

2 The amount of Class B stock authorized would be 150,000 shares The following amounts would be issued

To debenture bondholders	15,500 shares
To preferred stockholders	67,500
To common stockholders	19,000
Total	102,000 shares

3 Some of the conferees suggested that consideration should be given to the elimination of the cumulative feature of the income bonds Others suggested that

in lieu of issuing two classes of new stock, A and B, one class only of new common stock be issued, and that an exchange of stock be made on the following basis

To bondholders per $1,000 bond	10 shares
To preferred stockholders, per share, $100-par value	10 shares
To common stockholders, per share	1 share

When Mr. George received this plan, he examined it carefully and wrote the following letter to one of its proponents, outlining several plans which he felt were much fairer for all parties

April 13, 1933

Dear Mr Trowbridge:

It seems to me that the principal suggestion embodied in your memorandum is the same in its essentials as the proposed reorganization plan which we considered at one of our recent meetings and is open to the same objections

The plan as set up accomplishes practically nothing except to extend the life of the company in the event of a continuation of the depression If in a moderately good year earnings are over $350,000 after interest, which is an estimate of what can be done with the set-up practically the same as it is now, we will have the same old overcapitalization which we have struggled with in the past The difference between the picture as at present and the new one would be that ownership is shifted

As far as the common stockholders of the company are concerned, an extension of life is not of the highest importance We might be considerably better off retaining as much as we can of our equity for a good year in the hope that the worst will not happen, rather than giving away a large part of our equity now to prolong the life of the company which is going to mean practically nothing to us if it is saved It is obvious that the operating officials of the company feel it important to keep the company going at all costs but I am not so sure that this is the position which the owners should take

Another objection to the plan as outlined is that it makes no provision for new capital In the event that business picks up there is no doubt that new capital will be required This is particularly true in a specialty business of our type where it is necessary constantly to develop new lines to remain in business

On the basis of an estimate of income (after interest) of over $350,000 in a good average year, the earnings on the present common would be over $10 a share In such a year it might be possible to trade out the accumulated preferred dividend for between 1 and 1½ shares of common as against 3 shares at this time, that is, it seems to me it would be considerably cheaper for the common stockholders to make their trade at the top of the cycle rather than at the bottom The stockholder today has two things (1) the management of the company, and (2) an opportunity to gamble with the other fellow's money As long as he is not gambling with the creditors' money control cannot

be taken away from him A set-up which gives two-thirds of the common equity to holders of the preferred, who, if anything, are in a worse position than the common stockholders, and still leaves the same complicated picture which we have now in a good year seems to me to be asking common stockholders to pay too much for what they are getting

To simplify the capital structure as a practical matter the 7% debentures must be turned into preferred stock or the preferred stock into income bonds To give preferred stockholders common at this time dilutes the equity entirely too much My position on the dilution of this common equity is not so much one of thinking that the plan as stated does not deal fairly with the common holders, as that the preferred is not in a position to ask for what it is getting The accumulation on the preferred cannot be construed as a creditor position These dividends have not been declared and the preferred stockholders have no chance whatever of getting them It is their money which is being used at the moment and they have no means of stopping its use excepting to deal with the creditors and the common stockholders.

The plan might be made entirely fair to the common stockholders by giving them one share of "B" stock for each share of common held, plus 4 warrants to buy the "B" stock at $5 (or some other price) a share These warrants should run for five or six years to give an opportunity to the common holder to have them in effect during the next period of good business If exercised, the warrants would give control of the company to the present common stockholders If exercised, also, $380,000 in cash would be realized by the company which might be used for the retirement of its first mortgage bonds, thus automatically simplifying the capital structure, or for working capital The set-up then would be as follows

$ 400,000, First Mortgage 6's
$1,550,000, 7% Income Debentures
22,500 shares $6 non-cumulative preferred stock (Class A)
86,500 shares common stock (67,500 to preferred and 19,000 to common stockholders)
76,000 warrants to buy common at $5

If the warrants were exercised, the first mortgage would disappear, and if they were not, the warrants would expire

I feel so strongly that the holders of the preferred stock ought to make a real sacrifice in the interest of simplification of the capital structure that the following scheme which looks toward the eventual elimination of the preferred has occurred to me Suppose each preferred stockholder instead of being given "A" stock, were given $40 par value in the new income bonds, plus three shares of common stock, and holders of the 7% debentures were given exactly what is proposed in your outline. The preferred stockholders would thus receive a large part of the equity plus something which today has a market value of two to three times that of their preferred stock The common stockholders might receive the same number of shares of common as are now

outstanding, plus sufficient warrants to retire the first mortgage bonds, when the warrants are exercised The set-up would be as follows

$ 400,000, 6% bonds
$2,450,000, 7% debenture income bonds
86,500 shares common
100,000 five-year warrants to buy common at $4

There should be no reintroduction of the cumulative feature in the income bonds

In the foregoing it has not been my intention to shoot the plan presented full of holes As a matter of fact I think it gives every indication of fairness and is a wise thing to do if it be conceded that something must be done at once, a concession which I do not believe is quite warranted by the facts I do think, however, it is highly desirable that every effort be made to simplify the capital structure so that the next ten years will not be like the last ten Although the management of the company has done a masterly job in operation, the board of directors has not done so well on the financial picture If some kind of string were attached to the gift of common stock to the preferred stockholders and bondholders enabling the present common holders to recover control, there should be no objection at all from the common stockholders to the committee's plan If we can change the plan, however, to eventually get rid of the preferred, it would be a real achievement

I have not regarded sinking funds or retirement features, nor the problem of getting the consent of the 7% bondholders to increasing the number of outstanding bonds It is possible that obstacles would be encountered here which could not be hurdled, but so many weird trades are being made now that it might be worth while to consider fairly radical steps in this direction

Yours sincerely,
C E GEORGE

1 Criticize or defend Mr George's position

2 Prepare a plan which would be most equitable to all parties

3 What factors do you consider most important in formulating a plan for recapitalizing a company?

4. CONVERSE RUBBER SHOE COMPANY[1]

REORGANIZATION OF AN INDUSTRIAL CONCERN

Although the Converse Rubber Shoe Company had been successful since 1908 in the manufacture of rubber boots and shoes and had established a good reputation for these products, it had encountered serious difficulty in 1927 and early 1928 in the manufacture of tires and tubes The company's financial condition was so serious in June and July, 1928, that a friendly creditor applied for a receiver, and on August 7, 1928, the court appointed Mr Morton L Paterson, who for years had been manager of the company's western branches and who had assumed the management of the company on June 14, 1928

Mr Paterson immediately made a thorough investigation of the company's condition and affairs. He stated that the western branches had been more profitable than the eastern because the former had encountered less price competition He also stated that the plant was in good condition and capable of as efficient operation as any other rubber shoe plant in the country He advised, however, the expenditure of $15,000 for new equipment in order to effect certain manufacturing economies On July 3, 1928, the plant had over $1,000,000 in orders for footwear, the manufacture of tires and tubes having been discontinued Mr Paterson presented the balance sheet as of June 14, 1928, shown in Exhibit 1.

At the time of his appointment the court gave Mr. Paterson authority to issue $100,000 of receivers' certificates whenever he saw fit The court required that these certificates be payable on December 1, 1928, at par plus interest, bear interest at 6%, and constitute a first lien on the property prior to all existing liens By September 10, 1928, $40,000 of receivers' certificates were outstanding

The court also authorized an emergency loan of $25,000 from the Manufacturers Finance Company, with which the Converse

[1] Reprinted from C E Fraser, *Problems in Finance*, 2d rev ed, McGraw-Hill Book Company, Inc, New York, 1930, p 620

EXHIBIT I
CONVERSE RUBBER SHOE COMPANY
Balance Sheet, as of June 14, 1928

ASSETS			
Cash		$ 44,855	
Notes & Accounts Receivable		352,752	
Inventories			
Finished Goods		635,634	
Raw Materials, Goods in Process, and Miscellaneous		213,622	
Investments		7,791	
Plant & Equipment		1,007,717	
Deferred Charges			
Unamortized Expense on Sale of Securities		91,274	
Prepaid Expenses		28,024	
Total Assets			$2,381,669
LIABILITIES			
Notes & Accounts Payable			
Trade Creditors and General		$ 472,449	
Banks and Bankers		320,000	
Debenture Notes or Bonds			
Due 1928–1929	$275,000		
Due 1932	161,400		
Due 1937	990,800	1,427,200	
			$2,219,649
Stockholders' Equity			162,020
Total Liabilities			$2,381,669

Rubber Shoe Company had done business previously On May 28, 1925, it had entered into a contract with this finance company whereby its receivables were to be financed for an interest charge of 6%. It was rumored, however, that premiums and commissions increased the total charge to about 30%

Representatives of the stockholders stated that the company's difficulties were due to mismanagement of the tire and tube business They claimed that defective tubes had been made, in spite of the warnings of the company's engineers, and that returns of those tubes cost the company thousands of dollars They also claimed that the refusal of the management to make proper delegation of authority to department heads had caused disorganization of the personnel Investment firms which had sold the notes of the company attributed its difficulties to three causes· the unsuccessful manufacture of tires and tubes, unfavorable weather for the wearing of overshoes and rubbers during 1926 and 1927, and forced liquidation of inventories to meet operating expenses Financial statements of the company for years previous to 1928 are shown in Exhibits 2 and 3

EXHIBIT 2
CONVERSE RUBBER SHOE COMPANY
Comparative Balance Sheet

	Dec 31, 1925	Dec 31, 1926	Aug 31, 1927
ASSETS			
Plant and Equipment*	$1,298,821	$1,229,056	$1,841,460
Trade-marks	622,218	835,764	579,538
Investments	64,779	804,579	500
Bills and Accounts Receivable	2,791,556	1,842,976	1,069,509
Inventories	2,033,096	1,535,389	1,692,526
Cash on Hand	191,565	59,215	57,878
Prepaid Expenses	304,882	490,463	398,672
Total Assets	$7,306,917	$6,797,442	$5,640,083
LIABILITIES			
Preferred Stock	$2,658,300	$2,897,800	$2,831,850
Common Stock† and Surplus	1,369,780	1,221,936	403,507
Debenture Notes	1,457,800	1,357,800	1,419,150
Notes Payable	855,000	870,000	702,942
Accounts Payable	386,859	293,912	270,406
Accruals	395,000		
Reserves	184,178	155,994	12,228
Total Liabilities	$7,306,917	$6,797,442	$5,640,083

* After depreciation
† Represented by 14,241 no-par common and 2,662 general capital shares

EXHIBIT 3
CONVERSE RUBBER SHOE COMPANY
Comparative Income Account, Years Ended March 31

	1923	1924	1925*
Gross sales	$5,746,876	$5,255,951	$4,405,121
Net sales	4,470,646	4,995,287	3,993,480
Cost of goods sold	2,980,115	3,724,107	2,389,459
Selling and administrative expense	790,853	835,175	919,004
Net operating revenue	699,678	436,005	685,017
Other income	19,516	150,655	4,541
Total income	719,194	586,660	689,558
Interest	211,367	204,350	489,056
Net income	507,827	382,310	200,502
Dividends	Not stated	165,464	193,248
Surplus adjustment		17,526	
Surplus		199,320	7,254

* Late income statements are not available, but men familiar with the company reported that a loss of about $2,000,000 was incurred during the period Mar 31, 1925, through Aug, 1927, and that this loss was due largely to mismanagement of the tire business

During July, 1926, protective committees for the stockholders and the bondholders were formed The stockholders' protective committee suggested the following plan of reorganization:

1 The issuance of $500,000 of first mortgage bonds
2 The sale of the property to a new company.

EXHIBIT 4
CONVERSE RUBBER SHOE COMPANY
Pro Forma Balance Sheets

	Before reorganization	After reorganization
ASSETS		
Cash	$ 43,977	$ 345,074
Accounts & Notes	352,537	352,537
Inventories	849,255	849,255
Plant & Equipment	1,007,718	1,207,717*
Deferred Charges	142,079	192,079
Goodwill		250,000†
Total Assets	$2,395,566	$3,196,662
LIABILITIES		
Notes & Accounts Secured & Preferential	$ 148,904	
Notes & Accounts	623,260	
Accrued Expense	16,963	$ 16,963
Debenture Notes & Interest	1,468,169	1,254,857
Mortgage Bonds		500,000
Preferred Stock, Common Stock (Stockholders' Equity)	138,270	1,424,842
Total Liabilities	$2,395,566	$3,196,662

* The receiver, Mr Paterson stated that this $200 000 increase in the valuation of plant and equipment was justified

† Goodwill was included on the ground that the company would be continued as a going business

3 The distribution of stock (*a*) 1 share of common for each share of preferred outstanding, (*b*) 1 share of common for each 3 shares of common outstanding, (*c*) 1 share of common for each 3 shares of general capital stock outstanding

An argument against the proposed bond issue was the fact that the two outstanding issues of bonds had provisions that no mortgage or prior lien might be placed on the assets [1] In favor

[1] In one issue of bonds the provision was to the effect that no mortgage or prior lien might be placed on the assets unless that issue was equally secured under the mortgage

of the proposed bond issue, however, was the contention that these provisions were of no effect since, according to the Massachusetts state law and the by-laws of the corporation, the decision as to the placing of a mortgage upon the property rested with the stockholders.

EXHIBIT 5

CONVERSE RUBBER SHOE COMPANY

Estimated Profit and Loss Account, Year Ended March 31, 1929

Net Sales		$4,000,000
Cost of Goods		2,375,053
Gross Profit on Sales		$1,624,947
Ratio to net sales		40.6%
lling and Administrative Expenses		
Advertising		$ 35,000
Allowances and Deductions		500
Collection Charges		12,500
Commercial Agencies		5,000
Department Jobs		35,000
Discount—Cash		48,000
Discount—Volume		30,000
Discount—Jobber		50,000
Freight In—Branches		1,000
Freight In—Customers' Returns		6,000
Freight Out—Branches		35,000
Freight Out—Customers		65,000
General		7,500
Insurance Costs		2,000
Light, Heat, and Water		4,000
Postage		7,500
Rent		37,000
Repairs and Renewals		4,000
Salaries—Employees		100,000
Salaries—Executives		45,000
Salesmen's Commission		280,000
Salesmen's Samples		7,500
Shipping		75,000
Shipping Supplies		4,000
Stationery and Office Supplies		15,000
Telegraph		4,000
Telephone		5,500
Traveling Expenses		8,000
Uncollectible Accounts		40,000
Welfare		1,500
Total before Interest, Taxes, and Depreciation		$ 970,500
Ratio to net sales		24.3%
Interest	$200,000	
Taxes	30,000	
Depreciation	36,427	
Total		$ 266,427
Ratio to net sales		6.7%
Net Profit		$ 388,020

This first plan was incomplete and was prepared only for the purpose of discovering the reaction of the security holders' protective committees. In September, therefore, the stockholders' protective committee advanced another plan as follows.

1 To issue \$500,000 of first mortgage bonds at 90.
2 Trade creditors, noteholders, and bondholders to take new 6% debentures to an amount equal to 60% of their claims
3 Preferred stockholders to take 1 share of new common stock for each 2 shares now held
4 General capital stockholders to take 1 share of new common stock for each 2 shares now held.
5 Common stockholders to take 1 share of new common stock for each 10 shares of common now held
6 Trade creditors and noteholders to be paid in cash at 33⅓% of face value if sufficient cash be realized from adjustments for fractional shares arising from the cancellation of old stock and the issuance of new
7 A reserve of 15% of profits to be set aside each year for redemption of debenture notes

In order to facilitate a decision as to the plan of reorganization suggested in September, the stockholders' protective committee submitted a balance sheet and an estimated profit and loss account covering the fiscal year's operations, as shown in Exhibits 4 and 5

What action should the bondholders' protective committee have taken on the second of the proposed plans?

5 WALWORTH COMPANY (III)[1]

REORGANIZATION

At the meeting on March 9, 1933, the directors of the Walworth Company decided to defer payment of interest on the mortgage bonds and debentures of the parent company On May 10, 1935, the company filed a petition in the United States District Court at Boston to reorganize under the Corporate Bankruptcy Act (Sec 77B of the National Bankruptcy Act) This petition was granted. Subsequently a plan of reorganization was proposed The following data are excerpts from this plan

PART I INTRODUCTORY

The Plan hereby proposed has been formulated after extended consultation and collaboration by Walworth Company (hereinafter called the Company), a committee which has been acting since April, 1933, in the interests of the Company's outstanding first mortgage bonds (hereinafter called the Bond Committee), and another committee which has been acting for the same period of time in the interests of the Company's outstanding debentures (hereinafter called the Debenture Committee). The Company and both of said committees are satisfied that the Plan is fair and equitable and does not discriminate unfairly in favor of any class of the creditors or stockholders of the Company and is feasible, and have agreed to use their best efforts to bring about the acceptance, confirmation and carrying out of the Plan without material alteration The activities in this respect of the two committees above referred to will be supplemented by a third committee called the Company's Committee on Reorganization which has been appointed by the Company and will in general cooperate with the other two committees in seeking to obtain the acceptance of the Plan by all parties in interest and will more particularly assume the burden of presenting and explaining the Plan to the stockholders of the Company and obtaining so far as possible their acceptance thereof . . .

Necessity for Reorganization

On April 1, 1935, the Company owed $1,343,012 50 accrued interest on its bonds and debentures On October 1, 1935, the principal of the

[1] In studying this case it is suggested that the cases of the Walworth Company (I) and (II), pp 236 and 243, be read

debentures matures, amounting to $1,673,000. The Company cannot make payment of these sums in cash The bondholders and the debenture holders, therefore, must be paid in securities of the Company

Interest on the Company's present funded debt is accruing at the rate of $537,205 annually, and no part of this interest was earned in 1931, 1932, or 1933 The consolidated earnings of the Company and its subsidiaries for the year 1934, applicable to the payment of this interest, after charging $454,451 30 to depreciation, were $318,916 89 It is clear therefore that the Company's fixed interest charges must be reduced

On account of the Company's failure to meet interest payments upon its first mortgage bonds as such interest payments became due, the principal of these bonds, amounting to $7,141,000, may be declared due and payable by the trustees at any time

This situation cannot continue and the Company must be either liquidated or reorganized

If, instead of curing the financial difficulties above referred to by a reorganization, the Company were liquidated, its value as a going concern would be destroyed Both its current assets and its fixed assets would have to be disposed of at extremely low prices The result would be disastrous to creditors and also to stockholders By a reorganization, however, the going-concern value of the Company will be preserved

The Company's business was established in 1842. It has a high standing in the industry, and in the manufacture and sale of valves and pipe fittings it is the second largest company in the country. While it has suffered severely in the depression, this has been true of many other companies and of practically all the companies engaged in the so-called "heavy industries" The Company has fully maintained its relative position in the industry

During the depression it failed to show (on a consolidated basis) an operating profit, before depreciation and interest, only in the years 1931 and 1932 In 1933 it partially earned (on the same basis) its depreciation and in 1934 it earned (on the same basis) its depreciation plus $318,916 89 applicable to the interest on its own bonds and debentures Such a company should be reorganized, not liquidated

General Discussion of the Form of the Plan

The principal objects which the plan seeks to accomplish are (1) to provide for the interest accrued and unpaid on the bonds and debentures and the payment of the debentures which are immediately payable, (2) to reduce interest charges, and (3) to extend the maturities of the funded debt

In formulating the plan of reorganization it has been kept in mind that except to the extent necessary creditors should not be expected to give up their rights to accrued interest or to reduce the interest rates or the principal of the securities held by them and accept common stock in exchange therefor. On the other hand, it is not in the interests of

any security holders that the reorganized company should be burdened by fixed interest charges or an amount of debt, or with nearby maturities, which the Company probably could not pay The present plan attempts to meet these conditions as fairly as possible

Under the proposed plan the fixed interest charges of the Company itself from now on, before the operation of any sinking fund provisions, will be \$335,830 as against \$537,205 as at present For the year 1934 the consolidated net income of the Company and its subsidiaries available for interest charges on the funded debt of the Company was \$318,916 89 These earnings, however, were diminished by certain payments and charges which the management believes will be non-recurring

If earnings continue at the rate prevailing for the past eighteen months the management is confident that the Company will be able to meet its new interest requirements and under the plan the Company will have no maturities on its funded debt for twenty years

It is obvious that creditors cannot be asked to accept common stock for their accrued interest and their claims if such common stock is subject to a preferred stock or to prior accumulated dividends. The plan, therefore, further provides for the simplification of the capital structure of the Company by the elimination of the preferred stock with its accumulated dividends and the conversion of such preferred stock and dividends into common stock

Skeleton Outline of Plan

In brief the Plan contemplates, as more fully set forth therein, the following readjustments

a Holders of the outstanding First Mortgage 6% Bonds to receive for each \$1,000 bond and accrued and unpaid interest thereon to April 1, 1935, \$1,000 in principal amount of new first mortgage 4% bonds due April 1, 1955, with interest accruing thereon from April 1, 1935, and 70 shares of common stock

b Holders of the outstanding 6½% Debentures to receive for each \$1,000 debenture and accrued and unpaid interest thereon to April 1, 1935, \$500 in principal amount of new 6% debentures due April 1, 1955, with interest accruing thereon from April 1, 1935, and 130 shares of common stock

c Holders of preferred stock to receive for each share held (together with all accumulated and unpaid dividends thereon) 8 shares of common stock

d Holders of common stock to retain their present holdings.

All existing obligations of the Company other than those above mentioned, including salaries, wages, and all current accounts payable, except interest as aforesaid, are to remain wholly unaffected by the Plan and are to be paid in full in cash, except that certain executory contracts of the Company hereinafter referred to, including its liability

on certain outstanding stock purchase warrants, may be rejected by the Company if the Court shall so direct upon the petition of the Company or otherwise and settlement therefor made as hereinafter provided.

EXHIBIT 1
WALWORTH COMPANY
Description of Proposed Bond Issues

1 *Twenty-year 4% first mortgage bonds, due April 1, 1955*
Authorized, $7,141,000
Callable as a whole or in part on any interest date at par.
Sinking Fund —On or before June 1, in each year beginning with the year 1938, the company shall pay to a sinking fund a sum in cash or the equivalent in bonds equal to 20% of the net earnings of the company and its subsidiary companies for the preceding fiscal year
Secured by a first mortgage indenture upon all the land, rights in land, buildings, structure, machinery, equipment, tools, appliances, patents, trade-marks, and goodwill, and likewise upon the common stocks of the Walworth Alabama Company, Westcott Valve Company, and Walworth Patents, Inc
So long as any bonds are outstanding company is to pay no dividends (except stock dividends) on its stock or directly or indirectly purchase any of its stock or make any distribution of its assets to its stockholders unless immediately after the making of such payment, purchase or distribution, either
(1) the total current assets of the company shall be at least equal to the total debts of the company, or
(2) the net current assets of the company shall be at least $5,000,000

2 *Twenty-year 6% debentures, due April 1, 1955*
Authorized, $836,500
Callable as a whole or in part on any interest date at par
Sinking Fund —On or before June 1, in each year beginning with the year 1938, the company shall pay to a sinking fund a sum in cash or equivalent bonds equal to 5% of the net earnings of the company and its subsidiary companies for the preceding year
The provisions of the existing indenture as to the pledging and mortgaging of its assets by the company shall be replaced by a provision in the same form as the provision with regard to such pledging or mortgaging which is to be contained in the new mortgage bonds
So long as any debentures are outstanding the company will not pay any dividends except as allowed under the provisions of the new mortgage bonds

Condensed from Plan of Reorganization

It is planned that the above readjustments shall be made by the existing corporation by authorizing the new bonds and debentures above referred to, and increasing the amount of its common stock, and issuing the new bonds and debentures and the additional common stock as above stated, but if it is found legally necessary or advisable to do so a new corporation will be formed to which the Company will convey its assets and which will issue and distribute as above stated its new bonds, debentures, and common stock, and assume the other obligations of the Company which, as above stated, are to be unaffected by the Plan

PART II THE PLAN

Detailed Statement of Securities to be Included in the Plan

The securities of the Company which are to be included in the Plan are as follows, namely

First Mortgage 6% Bonds due October 1, 1945	$7,141,000 00
6½% Debentures due October 1, 1935	1,673,000 00
6% Preferred Stock, par $50, 19,860 shares	993,000 00
Common Stock, no par, 357,860 shares	

The Plan will also include all interest on the aforesaid bonds and debentures from and after October 1, 1932, and all dividends accumulated and unpaid on the aforesaid preferred stock from and after April 1, 1931 As of April 1, 1935, the aforesaid accrued interest and accumulated dividends were as follows

Accrued interest on bonds	$1,071,150 00
Accrued interest on debentures	271,862 50
Accumulated dividends on preferred stock	238,320 00

Detailed Statement of Securities to be Outstanding upon Completion of the Plan

It is proposed that the Company (or new corporation) shall have authorized and outstanding upon completion of the Plan in place of the securities and obligations above described, the following securities, [see Exhibit 1] namely

	Authorized	Outstanding
Twenty-Year 4% First Mortgage Bonds dated as of April 1, 1935, due April 1, 1955	$7,141,000	$7,141,000
Twenty-Year 6% Debentures dated as of April 1, 1935, due April 1, 1955	836,500	836,500
Common Stock, which shall be either without par value or with such par value as may be determined in the matter hereinafter provided as to other matters of detail	1,350,000 shares	1,234,100 shares

Creditors Not Affected by Plan

All creditors with claims existing at the time of the filing of the petition in the proceeding in which this Plan is proposed, other than claims for the principal and interest of the outstanding bonds and debentures, including all claims for taxes, salaries, wages, other compensation for services and merchandise sold to the Company, and all other claims for the payment of money, shall be wholly unaffected by

EXHIBIT 2
WALWORTH COMPANY AND SUBSIDIARIES
Consolidated Balance Sheet

	Dec 31, 1934*	Mar 31, 1935†
ASSETS		
Cash	$ 631,809	$ 646,324
Marketable Securities (at market value)	7,025	8,525
Notes and Accounts Receivable, Less Reserves	1,037,157	1,017,051
Inventories (at lower of cost or market)	3,410,105	3,583,235
Total Current Assets	$ 5,086,096	$ 5,255,135
Other Notes Receivable	194,902	194,188
Miscellaneous Securities	68,572	68,396
Cash Held by Trustees	129,953	123,609
Plant and Equipment, Less Depreciation	13,111,619	11,934,673
Patents and Goodwill	1	1
Prepaid Expenses and Deferred Charges	97,184	102,725
Total Assets	$18,688,327	$17,678,727
LIABILITIES		
Accounts Payable and Accrued Expenses	$ 500,260	$ 528,473
Walworth Alabama Company Bonds Due August 1, 1935	27,000	27,000
Interest on Bonds and Debentures		
Matured and Unpaid	1,074,410	
Accrued	134,301	
Total Current Liabilities (exclusive of debentures maturing in 1935 shown below)	$ 1,735,971	$ 555,473
Ten-year 6½ % Sinking Fund Debentures Series A, Due Oct 1, 1935‡	1,673,000	
Total Current Liabilities and Debentures Maturing in 1935	$ 3,408,971	$ 555,473
First Mortgage 6 % Sinking Fund Bonds, Series A, Due 1945	7,141,000	
First Mortgage 4 % Sinking Fund Bonds, Due 1955		7,141,000
6 % Sinking Fund Debentures, Due 1955		836,500
Walworth Realty Company First Mortgage 6½ % Sinking Fund Bonds, Due 1942	207,300	201,200
Reserve for Contingencies	180,420	169,333
Special Reserve for Amortization of Plant and Equipment§	1,038,166	‖
Walworth Alabama Company Preferred Stock, 7 % Cumulative¶	280,125	284,062
Preferred Stock,** 6 % Cumulative, Par $50	993,000	
Common Stock	7,092,285††	8,491,159‡‡
Surplus Arising from Appreciation of Plant and Equipment	3,949,769	
Earned Surplus	5,602,709[d]	
Total Liabilities	$18,688,327	$17,678,727

* Contingent liabilities—foreign drafts discounted $46,852 Securities pledged all common stocks of subsidiary companies owned by Walworth Company and $10 000 of miscellaneous securities included in assets above are pledged with trustees under the Walworth Company first mortgage bond indenture

† Pro forma balance sheet prepared from company's books to show effect of proposed reorganization plan

‡ Sinking fund payments in case of debentures to retire a total of $300,000 face amount are in arrears

§ Provided from surplus arising from appreciation of plant and equipment

‖ Special reserve has been deducted from the account, Plant and Equipment

¶ Includes accumulated dividends $55,125 as of Dec 31, 1934, $59,063 as of Mar 31, 1935

** Fifteen quarterly dividends unpaid Authorized and issued 20,000 shares, less 140 shares in treasury, outstanding 19,680 shares

†† No par value Authorized 500,000 shares, reserved against warrants 40,740 shares, less 400 shares in treasury, outstanding 357,840 shares

‡‡ Common stock authorized 1,350 000 shares, outstanding 1,234,100 shares

[d] Deficit

Condensed from Plan of Reorganization

the Plan and shall be paid in full in cash either at the time of the completion of the Plan or, so far as may be ordered by the Court, at such earlier time as the Court may fix, and upon such proof thereof as the Court may require.

Exhibit 3
Walworth Company and Subsidiaries
Earnings

The following table shows for the years 1926 to 1934 inclusive, as annually reported by the Company and its subsidiary companies, in Column A the consolidated net income (or in italics loss) of the Company and its subsidiary companies from all sources after depreciation and all taxes including federal income taxes, but before the payment or accrual of interest on funded debt, in Column B the interest on funded debt, and in Column C the balance of profit (or in italics loss), after payment or accrual of such interest

Year	A Consolidated net income as above	B Interest on funded debt	C Balance of profit or loss
1926	$1,261,588 38	$699,680 23	$ 561,908 15
1927	1,076,018 75	691,308 77	384,709 98
1928	1,066,966 38	653,781 49	413,184 39
1929	2,637,520 32	605,680 01	2,031,840 31
1930	778,110 07	614,496 68	163,613 39
1931	*1,470,447 68*	592,107 74	*2,062,555 42*
1932	*738,703 28*	567,869 87	*1,306,573 15*
1933	*307,339 68*	558,539 35	*865,879 03*
1934	335,045 70	553,333 81	*218,288 11*

For the three months ended March 31, 1935, the consolidated net earnings of the Company and its subsidiaries available for interest on bonds and debentures, as shown by the books of account (subject however to annual audit and to year-end adjustments relating to inventories, reserves, etc), were $90,158 74, and interest on the bonds and debentures outstanding [as of March 31, 1935] was $134,301 24, leaving a deficit for the quarter of $44,142 50 For the corresponding period in 1934, the earnings as aforesaid were $235,552 89 The interest was $134,309 37 and there was a balance of profit of $101,243 52

Source Plan of Reorganization

Exhibit 2 presents the consolidated balance sheet as of December 31, 1934, and a pro forma balance sheet showing the effect of the proposed reorganization. Exhibit 3 shows the earnings of the company and its subsidiaries for the years 1926 through 1934.

1. Why was the reorganization of this company necessary?

2. Was the plan of reorganization fair to (*a*) creditors, (*b*) bond and debenture holders, (*c*) preferred and common stockholders?

3 If you are critical of the plan, what changes would you propose?

6 IN RE STUDEBAKER CORPORATION[1]

REORGANIZATION UNDER SECTION 77B

SLICK, District Judge

The principal questions for decision are insolvency and the fairness of the reorganization plan submitted The Bankruptcy Act, of which the law under which we are acting in the case at bar is an amendment (section 77B [11 USCA § 207]), provides "A person shall be deemed insolvent whenever the aggregate of his property shall not, at a fair valuation, be sufficient in amount to pay his debts" Section 1 (15), 11 USCA § 1 (15) During the hearing counsel for opponents conceded that this definition controls here A person or corporation is therefore insolvent when he or it is unable to pay debts, and this inability to pay debts is not temporary, through lack of ready funds, but permanent through lack of assets convertible in a reasonable time, not necessarily at forced sale, but nevertheless within a reasonable period Insolvency under the statute and from a commercial standpoint results from inability to pay If the assets will not sell on the market within a reasonable time for enough to liquidate the debts, insolvency exists

Here we have a large manufacturing company in receivership for a period of close to two years, and under competent, honest, and efficient management Every effort has been made to succeed The receivership resulted because of lack of working capital, coupled with lack of funds to pay then existing indebtedness The court is not presently interested in the causes that combined to bring this once successful industry to disaster True, during the prosperous ten years shortly before receivership it was earning and paying dividends, but in February, 1933, it found itself in a position where it could not carry on Its accounts and bills payable were over $5,000,000 Its cash resources were practically exhausted

After receivership drastic economies were applied in its fixed overhead charges, and a strenuous effort made to show profits An indebtedness of nearly $15,000,000, which had provisions for amortization over a period of ten years, was declared in default, which was within the legal rights of the holders of these securities, bringing the indebtedness, including interest, to the staggering total of over $20,000,000 This does not include receivership and trustees' obligations of over $3,000,000

Every effort has been made to succeed, but circumstances, over which the court and its receivers had no control, have combined to retard and prevent success An enumeration of these determining

[1] District Court, N D Indiana, 1935 9 F Supp 426

causes would serve no useful purpose now The outstanding obstacle was the discouraging effect of the receivership on the sales organization and the buying public Sales resistance, because of the receivership, has been most discouraging and is absolutely impossible of determination

Many other reasons could be assigned for the failure of the receivers to make a better showing, but these same reasons convince beyond doubt that the present set-up cannot longer continue Either there must be a reorganization and sufficient working capital made available, or the assets must be liquidated, reduced to cash, and distributed to the creditors If this is done, under the great preponderance of the evidence the creditors will not receive the full amount of their claims The inevitable result of all this is that the debtor is now clearly insolvent Tragedy, yes, but how to have prevented it is a question the answer to which I have searched the record for in vain

The stockholders, common and preferred, are the owners They have had two years to come forward with the necessary money, or a plan to raise it, to pay off the creditors Nothing has been done and no constructive plan suggested Doubtless many of the stockholders are impoverished to the point where this is impossible For these unfortunates no one has deeper sympathy than this court Others without doubt could, if they would, furnish either all or a part of the necessary funds

When the company was placed in receivership the court was called upon to decide whether to continue operations or wind up the business Receiverships are of two general classes that might be designated as constructive and destructive The first class requires courage, economy, hard work, and clear thinking The second class requires auditors, appraisers, marshals, and auctioneers Obviously the second class is the easier course for the court to follow and sometimes, indeed quite frequently, it is the only course open and the quicker the assets are marshaled, sold, and the proceeds paid to the creditors and the receivership wound up, the better But sometimes a court is justified in continuing the operations of an industry on the prospect of preserving it for the benefit of its owners Frequently it is difficult to decide whether to continue operations in the hope of bringing the industry out of its financial difficulties, or whether to wind it up as speedily as possible

If the court orders immediate liquidation, no amount of criticism will ever be able to say positively that success would have followed permission to operate On the other hand, if the court orders a continuation of operation and they fail and assets are wasted that could have been sold and applied to debts, the creditors are of course greatly dissatisfied. Studebaker was a good example This court could have chosen a receiver or receivers who would have been good wreckers and could have liquidated the assets, applied them to the payment of the debts, and wound up the receivership This would have entailed much less work and worry The responsibility of deciding whether to

liquidate or continue operations was not a light thing and was assumed with a full sense of its seriousness and far-reaching effects

The receivers could easily have lost vast sums to the great detriment of the creditors Let it be set down to their everlasting credit that they put every ounce of their ability and loyalty into the Herculean task of bringing this great industry through one of the most crucial periods of the country's financial and industrial crises, and this in the face of what to some seemed like insurmountable difficulties Two of these receivers are to be actively engaged in the new company under the reorganization plan submitted

For two years this court and its receivers have struggled on hoping for the impossible, it has not happened We are now faced with stern realities To continue to operate under present conditions could only result in ultimate disaster, not only to the creditors and stockholders, but to many others, who in the past have contributed to the success of this company To reorganize under the plan submitted will put the new company in a strong financial position and save something for both classes of stockholders, eliminate all present creditors, and bids fair to save a large and useful industry. The result, if successful, will be of inestimable value to the country at large, give needed employment, not only locally to thousands of wage-earners, but to employees in kindred industries from whom large supplies must be purchased In these times of industrial unrest it would seem that the court must consider these questions seriously before wrecking an industry by putting it on the auction block with all attendant consequences, and especially when 75 per cent of the creditors and 20 per cent of the stockholders are petitioning for the reorganization plan under consideration, and those not so petitioning are offering no alternative but destructive liquidation

The plan is not perfect, but it is the best—in fact, the only feasible one offered To refuse the plan spells disaster, to accept it offers a good opportunity for success The uncontradicted testimony of witnesses familiar with reorganizations similar in size and character to the present one is that the plan, when read and taken as a whole, is fair to all classes of creditors and both classes of stockholders To hold differently would be to decide against not only a fair preponderance, but all the evidence in the case

I therefore, in the light of this evidence, hold the plan fair

1. What reasons led the court to approve the reorganization plan? Were they sound?

2. What are the court's functions in corporate reorganization?

3 What effect does the American judicial precedent of perpetuating a corporate organization have on traditional theories of free private competitive enterprise?

4 Should a solvent corporation ever liquidate and go out of business? Under what conditions?

5. How long should investors try to rescue an unprofitable enterprise by subscribing new capital?

SUMMARY QUESTIONS

1 What is the difference between recapitalization and reorganization?
2 What generally leads to the necessity for recapitalization and for reorganization?
3 Is it in line with public interests to make reorganizations as simple and easy as possible?
4 What led to the financial troubles of each of the companies referred to in this section?

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VIII

FINANCIAL INSTITUTIONS

The financial officers of a corporation frequently have duties which bring them into contact with financial institutions, among the most significant of these are commercial and investment banks, credit companies, factors, and stock exchanges A knowledge of such institutions is therefore necessary to these officers for the proper carrying out of their functions. Consequently, familiarity with the purposes of these institutions is necessary for a comprehensive understanding of corporation finance.

Commercial Banks—The financial institution most frequently of importance to the corporation is the commercial bank The corporation turns to it for general banking services, for loans for seasonal needs and, unfortunately too often, for funds with which to expand plant and facilities

The relationship between corporations and banks should be close for two reasons. In the first place, loans are requested and credit is extended usually when there is special need, therefore confidence in the company's management and a knowledge of its affairs are necessary in order that the bank may extend the required accommodation. In the second place, the average corporation official can secure much good advice and valuable information from bankers, who are constantly dealing with many concerns in different types of business. It is customary for a company to furnish its banks with quarterly, or even monthly, statements of condition It is no longer considered "prying" into that company's private matters, for a bank to require complete information as basis for loans

In past years bankers extended so-called "lines of credit," which were agreements made annually between a company and its banks whereby the banks agreed to extend a certain maximum amount of credit to their borrowing customer, who in turn agreed to carry on deposit an average of at least about 20% of that amount. The "line of credit" practice largely disappeared dur-

ing the depression, and the less rigid arrangements which are taking its place are subject to more frequent reappraisal to meet changing conditions. It should be remembered in considering the functions and responsibilities of the commercial bank that it is loaning other people's—its depositors'—money, and must be ready to return the money on demand. The banker, therefore, must at all times exercise careful judgment in extending loans for the legitimate demands of business.

Investment Banking Houses.—A company ordinarily turns to an investment bank to secure long-term capital. The functions of an investment bank are to provide this capital through the distribution of a company's securities and to advise it on problems relating to capital financing.

An investment banker is the middleman between the company and the buyer of securities. He usually guarantees the sale of, or "underwrites," a proposed issue, thus assuming responsibility for providing a company with needed funds. In extending this guarantee and in selling the securities, the investment banker may, and usually does, obtain the cooperation of other banking houses, either to spread the risk, or to broaden the facilities for the sale of the security.

Investment bankers sometimes go further and assume the role of promoter, either to inaugurate a business or to plan a combination in order that they may distribute the resulting securities. There are grave dangers that their judgment may be one-sided in their attempts to get long profits in this field and that they may forget the interests of their investing clients.

Credit Companies and Factors.—Corporations are not limited to commercial and investment banking houses for working capital funds. Commercial credit companies and factors as sources of these funds have been coming more and more into prominence in recent years. Both groups operate on the basis of discounting selected receivables.

Commercial credit companies have developed with installment selling, and have taken care of the needs of industries in special fields selling goods of relatively high unit value, such as automobiles, refrigerators, and radios. Many of these commercial credit companies have been well managed and very profitable, and the banks which formerly hesitated to discount receivables of this kind are beginning to look enviously upon this business.

Factors have developed chiefly in the textile field, and today it is estimated that 80% of the textile sales are financed by factors; in more recent years they have also been utilized in other industries Although their principal function today is that of financing receivables, they often perform additional services, such as investigating and assuming the responsibility for credits and collections, acting as sales agents for producers, making cash advances upon merchandise or against approved sales, and frequently performing such services as billing and bookkeeping, and storing, shipping, and insuring goods

Stock Exchanges —The stock exchanges are the market places where stocks and bonds are bought and sold With wise management and regulation, the exchanges have in recent years vastly widened the scope of their activities, so that today their high standards have tended to raise corporation financial and accounting practices and thus indirectly to protect the investor Because of the maintenance of an active market in securities, they have enabled corporations large and small to obtain funds and the public to have a daily gauge of corporate security values Corporations must meet requirements of the exchanges in order to have their securities listed and traded

The Securities and Exchange Commission was established in 1934, to supervise and regulate the exchanges, to suppress fraudulent practices and improve standards in the markets, and to regulate the public utility holding companies as provided in the Public Utility Act of 1935 [1]

[1] See Appendix II, p 357, for a brief discussion of the Securities and Exchange Commission

1. ALANTOWN TRUST COMPANY

COMMERCIAL BANKING AND THE CORPORATION

Early in March, 1932, the directors of the Manufacturers National Bank, a large Virginia institution, were interested in the feasibility of acquiring control of the Alantown Trust Company at Alantown, Virginia. The directors asked Mr Cramer, one of the vice presidents of their bank, to examine the history and policies of the Alantown Trust Company and to determine, if possible, the reasons for its closing in November, 1931 They were anxious to determine whether or not the Alantown Trust Company had been receiving a reasonable share of the business in its district and whether or not its closing was due to unsound banking practices.

The Alantown Trust Company was chartered in 1909 under state laws as a trust company with full banking privileges A Mr Corlett had been the chief figure in the organization and had retained 52% of the stock of the bank Mr Corlett owned various enterprises and was one of the leading figures of Alantown

When the bank was organized in 1909 Alantown, which was located on the Atlantic coast, had a population of approximately 8,000 During 1925, 1926, and 1927 the town grew rapidly, however, and became widely known and much favored as a summer resort Property values rose rapidly, reaching a peak in 1929 Over 30 new hotels were registered between 1925 and 1929 During these boom years the town went heavily into debt building municipal piers, boardwalks, buildings, and roads, which were to make the town one of the finest summer resorts in the state Bank deposits distributed among the town's five banks reached a total of approximately $20,000,000 By 1930, Alantown had a year-round population of approximately 30,000 and a summer population of approximately 170,000

In the rapid development of Alantown the Corlett interests held a prominent position The golf club which Mr Corlett owned was advertised as the finest in that territory. In 1928

Mr Corlett organized the Corlett Hotel Corporation This corporation sold stocks and bonds to the townspeople and with the aid of the Alantown Trust Company built the largest and most elaborate hotel in the town. The Corlett Hotel, which opened in 1929, represented an investment of nearly $2,000,000.

Mr Cramer found that the Alantown Trust Company had grown slowly until 1925. Since the only two large manufacturing firms in the vicinity banked chiefly with large city banks, the Alantown Trust Company had had to secure its business from small retail and wholesale firms, from farmers, and from other individuals. During the following 4 years the bank grew very rapidly Bank deposits increased sharply during the summer months due to the increased sales volumes of the merchants and to the accounts opened by vacation residents who wished to take advantage of local banking facilities At the same time larger demands were made for funds to finance building operations, to finance inventories, and to aid in the general expansion of business In March, 1926, in order to finance the rapid expansion in business, the directors offered the stockholders of the bank rights to purchase for $100 an additional share of stock for each share held By September, 1926, all the rights had been taken up. Mr Corlett retained his 52% interest

In 1927, the president and the board of directors decided to erect a new bank building in order to handle more efficiently the increased volume of business To finance the building the Alantown Securities Company was formed with 5,000 shares of $50-par-value common stock which were sold to the stockholders and depositors of the bank

The securities company then obtained a 99-year lease on a corner property in the heart of the town With the remainder of the funds obtained by the sale of stock and with a bank loan which was secured by a mortgage on the property the securities company built a $300,000 building The bank leased the banking room and one section of offices for an annual rental of $12,000 The remaining space was rented by the securities company for approximately $40,000 annually.

Two years later, in 1929, when the bank took over the building and the lease to satisfy the mortgage, the stockholders in the development company felt that they had been mistreated Due to the similarity in corporate names and to the fact that many

officers of the bank, including Mr Corlett, were officers and directors of the Alantown Securities Corporation, many people purchased stock in the securities company under the impression that they were investing in the Alantown Trust Company Furthermore, no dividends had ever been paid.

The stockholders in the securities company expressed their dissatisfaction by withdrawing their business from the bank. Public opinion caused further withdrawals. Between 1929 and 1931 deposits in the Alantown Trust Company had declined from over $9,000,000 to less than $5,500,000 [1] The bank finally decided to absorb the securities company by increasing the number of shares of stock in the bank and effecting an exchange with the stockholders of both companies The stockholders in the bank received five new shares for each old share, the stockholders of the securities company received one new share for each ten shares held in the Alantown Securities Company

Loans made by the bank were primarily one-name paper, unsecured Occasionally two-name and sometimes three-name paper was discounted Since the sudden growth of the town, much of the personal element, which would normally exist between a small-town bank and its customers, had disappeared Mortgages on property valued during the boom formed the bulk of the collateral held by the bank Usually financial statements were not required, even for loans in excess of $1,000 During 1929, 1930, and 1931, when it became apparent that security was of some consideration, the bank began to ask for more collateral to secure the notes in its portfolio Unfortunately the only collateral available at that time was second and third mortgages By 1931, property had depreciated in value to such an extent that very often the value of the property was less than the amount of the first mortgage. These loans, nevertheless, were not written off, but were carried on the books of the bank at their face value

The Alantown Trust Company enabled the Corlett Hotel to remain in operation by loaning the corporation large sums of money on notes The bank rediscounted these notes with customers of the bank until the amount of such loans became so great that further discounting was impossible A large portion of the notes bore Mr Corlett's personal endorsement.

[1] See Exhibit 2 for trend of total United States bank deposits during this period

The bank's position was further aggravated, Mr. Cramer discovered, by the results of its investment policy. In 1925 the bank began the buying and selling of stocks At times 85% of the securities portfolio held by the bank was in stocks In 1927 alone, $250,000 was added to undivided profits as a result of realized appreciation on stocks Additions to undivided profits from this source declined in 1928, however, and substantial losses were taken in 1929, 1930, and 1931 Stocks in the portfolio on October 15, 1929, were not sold until demands for cash forced the bank to liquidate a substantial portion of these investments. When a block of stock was sold, the loss due to the decline in market value was written off against undivided profits as of the date of sale

EXHIBIT 1
ALANTOWN TRUST COMPANY
Balance Sheet, as of September 1

	1926	1930	1931
ASSETS			
Bonds and Mortgages	$ 175,376	$ 25,133	$ 126,014
Bonds and Mortgages, Pledged	490,750	567,190	524,031
Bonds and Stocks	1,361,560	1,989,281	859,503
Loans	6,160,666	5,795,251	4,357,974
Building, Lease, and Equipment	93,189	571,568	574,220
Other Real Estate	7,605	410,337	428,661
Deferred Charges	49,485	37,754	31,935
Other Assets	52,896	12,832	19,437
Bank Deposits	830,118	1,067,842	483,065
Cash and Cash Items	239,080	434,568	370,561
Total Assets	$9,460,725	$10,911,756	$7,775,401
LIABILITIES			
Capital	$ 455,000	$ 650,000	$ 650,000
Surplus	455,000	650,000	325,000
Undivided Profits	252,424	104,757	402,895
Time Deposits	3,223,947	4,410,276	2,524,133
Demand Deposits	4,568,279	4,551,251	2,861,768
First Mortgage Bonds	405,990	443,690	397,670
Bills Payable			509,600
Other Liabilities	100,085	101,782	104,335
Total Liabilities	$9,460,725	$10,911,756	$7,775,401

In August, 1931, the president and the board of directors resigned A Management Committee composed of five members was chosen from popular citizens to operate the bank A new board of directors was elected. The Management Committee on

assuming charge announced these changes to the public and at the same time made a lengthy statement in which they declared the future policies of the bank

In spite of these moves to restore confidence in the bank, the withdrawal of deposits continued Mr. Cramer learned that certain groups of depositors disapproved of the Management Committee. A dull summer season caused speculation concerning the solvency of the hotel and of the country club, two of the bank's largest customers Rumors persisted that the bank itself was unsound Two months later the bank was closed and turned over to the State Banking Commissioner for liquidation

The resources and liabilities of the bank as of September 1, 1926, 1930, and 1931 are shown in Exhibit 1

1. What were the functions of a commercial bank in Alantown?

2 Comment critically on the management of the Alantown National Bank What policies led to its difficulties?

EXHIBIT 2
ALL BANKS IN THE UNITED STATES
Total Number and Deposits

Date*	Number of banks	Total deposits (In millions of dollars)
1926—June	27,854	49,733
Dec	27,367	50,155
1927—June	26,765	51,662
Dec	26,416	52,909
1928—June	25,941	53,398
Dec	25,576	56,766
1929—June	25,110	53,852
Dec	24,630	55,289
1930—June	23,852	54,954
Dec	22,769	53,039
1931—June	21,903	51,782
Dec	19,966	45,821

* Nearest day to end of month for which material was available
Source Federal Reserve bulletins and *Annual Report*, Federal Reserve Board, 1931

2. PAGE AND DELANCY

INVESTMENT BANKING AND THE CORPORATION

Since the reorganization of their company in 1934, Page and Delancy, investment bankers, had sold only municipal and other bonds of the highest grade In 1936 these investment bankers were asked if they would be interested in raising $1,500,000 for the Rivoli Shoe Company At that time Page and Delancy had adequate capital The firm had regained some of the prestige previously lost, and it was ready to resume regular investment banking business at the first favorable opportunity

The Rivoli Shoe Company, launched in 1927, had had a unique career The managers, young men, had become convinced that the profitable operation of factories for women's shoes depended on the ability of a company to be flexible and to produce quickly new styles as they came into vogue They had come to believe, furthermore, that operating units should be small and located in different districts so that labor trouble could not possibly tie up all the factories at once The two young men leased their first factory in 1927 at a nominal figure They were so successful that by 1934 they owned, leased, or controlled nine different factories Between 1929 and 1934 total annual sales increased from $7,000,000 to $20,000,000, and during the same period, annual net profits rose from $350,000 to $2,000,000

The pressure for capital increased with the steady growth of the company. To supplement funds secured from the sale of 350,000 shares of common stock the officers obtained working capital from local chambers of commerce and by the sale of 7% preferred stock Furthermore, the company borrowed heavily from the banks In 1934 the company owed the banks $1,500,000, on which it was paying interest at the rate of 2% to 3%. Occasionally the company paid off all bank loans, but in doing so it used factors[1] for loans, both on receivables and on inventory.

[1] For a definition of the term "factor" see the case of the Parisian Silk Company, p 330

The officers of the Rivoli Shoe Company wanted some plan drawn up and executed which would raise $1,500,000 and at the same time be satisfactory on the following points:

1. It must provide for the retirement of the $350,000 issue of preferred stock.

2. It must leave voting control with the holders of the original common stock, although these owners were willing to have the common stock split 10 for 1 so that a small amount of it could be given with any new issue of preferred stock or bonds.

3. It must offer reasonably low total costs of financing. Since the preferred stock had been sold in small blocks to their friends and others on the basis of the statement, "You will get your money back almost any time you want it," the officers proposed to retire this issue in order to relieve themselves of any personal responsibility in connection with the sale of it. They expected, furthermore, that the rate of dividends or of interest on any new issue would be lower than 7%.

Page and Delancy proposed two alternative plans. Under the first, 6½% cumulative preferred stock would be issued. The stock would be callable at $110 per share and have voting rights only in case dividends were passed for an entire year. Such an issue might be sold, they said, if warrants to purchase common stock were attached. The cost of distributing this issue would amount to about 10% of its stated value, 6% would go to the bankers for underwriting and selling the stock, and approximately 4% would pay the legal, accounting, and other costs. The bankers pointed out that preferred stock would provide the permanent capital needed.

Under the second plan Page and Delancy proposed to issue for the shoe company 4½% ten-year sinking fund bonds secured by a mortgage on all the company's properties. The investment bankers advised establishing a sinking fund which would provide for the redemption of the bonds at maturity. The cost of underwriting and distributing this issue would be only about 4% of the total face value of the bonds. Financing by means of bonds rather than bank loans would, in the opinion of the bankers, place the company in a much safer position.

1 Should the investment banking firm have underwritten and distributed securities for the Rivoli Shoe Company?

2 If so, which issue should Page and Delancy have recommended?

3 In view of the fact that the Rivoli Shoe Company had maintained favorable relations with its banks and was paying a low rate of interest on the bank loans, would you advise its engaging the investment banking house to issue new securities?

4 How much would it cost the Rivoli Shoe Company to *issue* the 6½% preferred? The 4½% bonds?

5 What would be the annual charge for capital if raised by issuing 6½% preferred stock? By issuing 4½% bonds?

3 PARISIAN SILK COMPANY

FACTORING, ITS RELATION TO CORPORATE FINANCE[1]

The Parisian Silk Company, located in New York City, was a small but old and well-established jobbing company selling silk and rayon fabrics, chiefly to women's wear cutters-up on 30-day to 60-day terms In 1934 when Mr Ernst, the president, was having difficulty with additional bank loans, he considered the wisdom of financing the company's current needs for working capital through a factor

The company was originally established as a partnership in 1888 by two men who had been salesmen for a large silk manufacturing company In 1904 the older member of the partnership withdrew, the second partner and his son carried on the business At that time the company was incorporated and the stock purchased by members of the Ernst family In 1923 Mr. Ernst, Jr became president and managed the company

The company had never encountered serious financial difficulties until 1930, although for several years previous to 1930 earnings had been small and the management not aggressive Losses continued in 1931 and 1932, as indicated in Exhibit 2, but the company again showed a profit in 1933. During the first half of 1934, however, when the question of bank borrowing arose the income statement again indicated substantial losses

The company's losses from bad debts had been considerable averaging about 1% of sales annually. During the depressed conditions which had existed from 1930 to 1934 credit losses were 2% Mr Ernst personally acted on all important questions relating to credit He and his colleagues had close connections with their customers, most of whom were of long standing Mr. Ernst estimated that the cost of checking the customers credit approximated $3,000 annually.

There were two other sources of the company's poor showing One was the losses which the company had to take from time to

[1] For explanation of the evolution of a factor, see Exhibit 3

time on inventory. The other was the difficulty in decreasing expenses to keep them in proportion with the rapidly declining sales volume

A satisfactory relationship between the company and its banks had existed for many years Mr Ernst had borrowed heavily throughout the year from the banks even before the depression of 1929 During the same time substantial amounts had been withdrawn from the business in the form of salary and dividends When Mr Ernst discussed his loan with his banker in May, 1934, he owed the bank $180,000 and his merchandise creditors nearly $276,000 (see Exhibits 1 and 2) The banker did not refuse to continue making loans, but pointed out that the company had been borrowing steadily and depending on the bank for working capital He called attention to the fact that 1933 profits had been realized from inventory appreciation rather than from actual operations, and that the bank had lost some confidence in the company's management because of certain antiquated policies and because of the constant withdrawals of cash[1] by the officers The banker frankly stated that although he felt the company was a satisfactory banking risk in 1934, he believed that the president should realize that if the company's operations continued to be unprofitable the bank might have to stop loaning in the near future

Soon after the discussion with his banker, Mr. Ernst was approached by the representative of a factor who suggested that Mr Ernst contract with his concern for the financing of the Parisian Silk Company's working capital requirements The representative of the factor presented the following reasons for using a factor.

1 It advanced funds as needed for working capital
2 It acted as the credit department for a company and assumed the entire responsibility for credit losses
3 It offered numerous other services of real benefit

The factor advanced money at a rate of 6% per annum for the number of days the money would actually be used In addition there was a factoring fee of from 1½% to 4% of net sales for the guarantee and the use of various services offered by the factor The spread in factoring rates depended on the volume, working capital, type of business, type of customers, credit terms, and

[1] See Exhibit 2

EXHIBIT I
PARISIAN SILK COMPANY
Balance Sheet, as of

	Nov 30 1929	Nov 30 1930	Nov 30 1931	Nov 30 1932	Nov 30 1933	May 31 1934
ASSETS						
Cash	$ 63,356	$ 120,790	$120,156	$ 28,111	$ 15,487	$ 32,412
Notes Receivable (customers)	1,584	976	597	750	394	555
Accounts Receivable (customers)	547,861	314,948	284,707	208,029	253,241	363,018
Merchandise	539,967	436,814	209,232	164,377	245,069	245,119
Investments (quoted and salable)	164,753*			22,058	22 623	37,421
Life Insurance					9,628	9,628
Advances Against Consignment Merchandise		64,573	8,000	.		
Insurance Claims (since paid)				16,116		
Current Assets	$1,317,521	$ 938,101	$622,692	$439,441	$546,442	$688,153
Real Estate and Buildings						4,142
Machinery and Fixtures	5,682	4,968	4,227	3,531	2,448	1,944
Other Notes and Accounts Receivable	72,902	297	7,074	4,482	7,709	604
Investments (other than quick)		164,273†	164,093‡	142,004§	146,396‖	128,006¶
Due from Employees		9,258	19,852	18,901	14,699	16,290
Deferred			2,017	1,328	2,646	2,780
Total Assets	$1,396,105	$1,116,897	$819,955	$609,687	$720,340	$841,919
LIABILITIES						
Accounts Payable for Merchandise	$ 417,340	$ 275,889	$185,896	$192,868	$233,784	$275,883
Notes Payable to Banks	300,000	280,000	190,000	30,000	70,000	180,000
Accruals		3,927	5,890	1,345	2,806	3,367
Notes Payable to Officers					4,428	4,704
Current Liabilities	$ 717,340	$ 559,816	$381,786	$224,213	$311,018	$463,954
Net Worth	678,765	557,081	438,169	385,474	409,322	377,965
Total Liabilities and Capital	$1,396,105	$1,116,897	$819,955	$609 687	$720,340	$841,919

* Market value of securities, in excess of $200,000
† Market value, $129 000
‡ Market value, $95,000
§ Market value, $97,070
‖ Market value, $58,637
¶ Market value $48 736

services rendered, such as sales space, advances on seasonal merchandise, and details in connection with foreign and domestic shipments. He pointed out that cash was immediately available to the company from its receivables The most valuable function that a factor performed, and the one which the representative stressed, was the careful checking of credits and the entire responsibility for losses from that source. In many cases a factor was retained to do nothing else.

EXHIBIT 2
PARISIAN SILK COMPANY
Sales, Net Income, and Withdrawals, Years Ended November 30

	Nov 30 1929	Nov 30 1930	Nov 30 1931	Nov 30 1932	Nov 30 1933	May 31† 1934
Net sales	$3,450,000	$3,089,228	$2,701,418	$1,525,606	$1,591,703	$930,016*
Net income after taxes	34,000	95,988[d]	95,342[d]	26,775[d]	33,324	18,010[d]
Dividends—Withdrawals	58,000	26,083	24,062	25,920	9,476	14,547

* The first six months ordinarily accounted for 40 % of annual sales
† Six months' statement
[d] Deficit

Mr Ernst learned that the factor had had years of experience in credit work and had built up detailed files on the credit standing of most of the companies to which the Parisian Silk Company sold and might sell its products The factor's representative would make no definite statement about the fee to be charged without further investigating the company's customers and its financial status, but he intimated that the rate would probably be about 1½% for guaranteeing and the usual 6% for cashing accepted receivables When his concern accepted receivables, it generally did all the billing and collecting Although no "line of credit" deposit such as was required by banks was demanded by the factor, nevertheless only 80% to 90% was immediately advanced on the face value of the receivables. The factor retained a balance of 10% to 20% of these receivables as an equity against which past due accounts resulting from such causes as returned merchandise and goods in dispute could be charged back

The president of the Parisian Silk Company hesitated to deal with a factor because he knew little about factoring and because he was afraid it would react unfavorably upon his bank credit. His average borrowings from the bank for the first six months of 1934 had been $250,000 for which the bank charged him 5%

interest. In investigating factoring he learned that in 1934 there were about 17 recognized factoring houses in New York City and that from 60% to 80% of the business in finished textiles was factored After his investigation he believed that a factor might prove valuable to him

When the representative of the factoring concern visited the president of the Parisian Silk Company a second time, he pointed out that since the factor insured against credit losses the company could assume more risks in selling, thereby increasing the sales volume, reducing overhead as a percentage of sales, and increasing profits The company could also save money by using the cash which would be available to take discounts on all purchases In addition, Mr Ernst would be relieved of the responsibility of the credit functions which the factor would perform as well as of the expense incident to credit checking and the worries related to collection Mr Ernst would then be free to devote himself to making favorable purchases and profitably distributing the merchandise

EXHIBIT 3
EVOLUTION OF THE FACTOR[1]

The earliest factors were merchandising agents who received goods for sale at a fixed commission In their evolution those factors who were able to advance cash against goods were preferred In this way the advancing of money became one of the essential functions of a factor's occupation

The courts have done much to clarify the legal status of factoring, and it is possible to trace the evolution of the factor by a series of legal decisions English common law in determining the factor's legal status distinguished between the factor and the merchandise broker, who lacked possession and control of the actual goods "At common law a factor who makes advances on goods consigned to him has a lien on the goods "[2]

In *Whigham v Fountain*, 132 Ga , 277, it was determined that "a factor is one who not only receives goods and merchandise for hire but, being entrusted with the possession, control and disposal for his principal upon commission, has a lien for all advances made thereon and expenses incurred in respect thereto "

The first Factor's Act was passed in England in 1823, and in the United States by the State of New York in 1830 The result of these statutes was to define the relationship between the factor and his principal In the main these common law relationships made possession conclusive evidence that the factor in possession as the apparent owner is the real owner of the merchandise until the factor's advances on the goods are liquidated

A New York decision in 1867 held that "Commission merchants to whom property is consigned by the owners for sale are *factors* of the owner " In *Shoyer v Ginsberg*, 240 N Y , 223 (1925), the word "factor" was decided to mean simply the making of advances on goods by a financial house As the technique of factoring was developing over the years, the significance of the word "factor" was increased by the inclusion of advances, not merely on merchandise, but against accounts receivable as well

[1] Condensed from *The Factor*, February, 1934 pub by James Talcott, Inc
[2] *Heard v Russell*, Ga 1877, *Gragg v Brown*, Me 1857, *Owen v Iglanor*, Tenn 1867

EXHIBIT 3 (*Continued*)

The decision in *Ryberg v Snell*, U S 1809, No 12190, stated that possession may be either "actual or constructive" This was an important clarification, since actual possession had been considered necessary for the preservation of the factor's lien The next important step forward was made when the factor's rights in the merchandise were recognized, even though they remained in the principal's own warehouse In *J F Brown Co v Harris*, 88 S C, 558, the courts upheld this principle by deciding that the factor had a lien on the goods against which he had made advances, even though they remained in the principal's warehouse, since the merchandise had been constructively delivered The further extension of this principle was applied in *Burrows v Kyle*, 56 Ga, 24, where the factor can show possession through agents

In *Talcott v Chew*, 27 Fed 275, 1885, the court established the rule that "when factors have made large advances or incurred expenses, the principal cannot control the factor's right to sell so long as they act in good faith and with reasonable skill"

The increasingly important function of guaranteeing credits on the part of factors led in the case of *Talcott v Canton Mills Company*, 30 N Y Supp, 421, 1895, to the enunciation of the principle that "a factor who guarantees sales made by him on commission is entitled to credit for goods which he has sold and charged to himself in his account of sales, but afterwards received back from the buyers, pursuant to authority given by his principal to settle a dispute as to quality, or recovered from the buyers for fraud in procuring the sale"

Although the decisions cited tend to emphasize the merchandising importance of the factor, it should be remembered that the factor gradually assumed the vastly more important functions of investigating credits and the purchase of accounts receivable either with or without recourse on the seller, even when the factor did not effect the actual sale of merchandise The importance of the financial aspect of factoring was enhanced by the widening of the market and its attendant decentralization, which forced manufacturers to form their own sales organizations in order to participate in the broadening demand for merchandise of all kinds

1 What financial problems confront the Parisian Silk Company?

2 To what extent would employment of a factor solve these problems?

3 If the banker's criticism of the company was justified, why would the factor be warranted in extending credit?

4 Assume the credit terms of merchandise trade creditors were 2%, 10 days, net, 30 days, what rate per annum would the Parisian Silk Company be paying its trade creditors by not taking the 2% ten-day cash discounts?

5 If you were a trade creditor of the Parisian Silk Company, what changes, if any, would the company's shift in financial methods cause you to make in your credit policy?

6 What action should the company's banker take on the line of credit, if the factor is employed?

7 Should the president of the Parisian Silk Company have used a factor?

4 COMMERCIAL CREDIT COMPANY (II)

THE RELATION OF COMMERCIAL CREDIT AGENCIES TO BUSINESS

On pages 151 and 152, the functions of the Commercial Credit Company are outlined Balance sheets and income statements, shown on pages 153, 154, and 155, describe the financial position of the company. These operating figures indicate the extent to which manufacturers, wholesalers, and retailers have utilized this credit company.

1 What led to the rapid growth of the Commercial Credit Company?

2 How profitable was the company?

3. Do the risks involved in this business appear great? Substantiate your answer

4 Why did other financial institutions such as banks not engage in this type of business?

5 Have credit companies such as this been a real aid to business?

5 TATEM COMPANY

LISTING SECURITIES ON THE STOCK EXCHANGES[1]

Officials of the Tatem Company were considering, early in 1935, the listing of the company's common and preferred shares on one of the stock exchanges The Tatem Company, a Massachusetts corporation, had operated successfully for many years, manufacturing taps and dies and a wide line of machine tools The company had always been conservatively managed and controlled by one family There had been only 30 stockholders until 1929 when an investment house purchased a part interest The wider distribution of ownership resulting from this transaction stimulated interest in the question of listing

The Tatem Company had been founded in 1850 but not incorporated until 1890 Soon after its founding the company established a reputation for high-grade products—a reputation which had always been maintained District offices were located in Boston, New York, Chicago, and Baltimore, sales offices were located in the principal cities of the United States. Foreign business was carried on by wholly owned subsidiaries Expansion had at all times been slow, and no funded debt had been incurred During the World War, operations proved highly profitable and income continued to be satisfactory until 1930, when sales volume began to decrease. Balance sheets and operating statements of the company for 1933 and 1934 are shown in Exhibits 1 and 2

The original capital stock of the Tatem Company had consisted of 35,000 shares of common stock, $100 par value, but from time to time rights to purchase new shares had been offered stockholders A substantial part of the large earnings of the war period had been retained in the business as surplus. In November, 1928, the management declared a 100% dividend on the

[1] For reference, see The Securities Exchange Act of 1934, James Edward Meeker, *The Work of the Stock Exchange,* Report on the Government of Security Exchanges, 74th Congress (House), Document 85, "Stock Exchange Practices," 73rd Congress, 2d Session, Senate Report No 1455

EXHIBIT 1
TATEM COMPANY
Consolidated Balance Sheet, as of December 31

	1933	1934
ASSETS		
Cash	$ 2,443,083	$ 2,500,570
Land and Buildings	4,034,420	3,646,334
Machinery	3,049,947	3,079,334
Furniture and Fixtures	1,559,707	1,366,592
Receivables (net)	3,383,061	3,179,443
Inventory (lower of cost or market)	4,638,515	4,785,080
Prepayments	149,034	138,622
Goodwill, Patents, etc	1,824,907	2,625,577
Investments and Loans	112,026	45,626
	$21,194,700	$21,367,178
LIABILITIES		
Preferred Stock	$ 9,500,000	$ 9,500,000
Common Stock	9,500,000	9,500,000
Mortgage	190,400	185,600
Payables and Accruals	638,195	536,458
Minority Interest	293,921	314,730
General Surplus	822,288	1,064,353
Surplus Reserves for Stock Purchase and Equity of Affiliates	249,896	266,037
	$21,194,700	$21,367,178

EXHIBIT 2
TATEM COMPANY
Consolidated Income Account, Years Ended December 31

	1932	1933	1934
Net earnings	$ 121,034	$ 10,970	$494,778
Depreciation and amortization	393,621	400,214	400,554
Inventory write-down	229,669	380,642	
Net income	502,256[d]	769,886[d]	94,224
Preferred dividends	854,835	131,664	259,520
Common dividends	19,440		
Deficit for year	1,376,531	901,550	165,296

[d] Deficit

Sales volumes for selected years were as follows

1921	$25,660,960	1931	$29,952,000
1926	33,704,320	1932	24,336,000
1929	34,944,000	1933	18,200,000
1934	$18,876,000		

common stock, payable in 7% cumulative preferred stock After the payment of this dividend and certain minor adjustments, the capitalization of the company was as follows

Preferred stock (par $100)	$9,500,000
Common stock (par $100)	9,500,000

Several of the stockholders, in 1929, felt that their interest in the company had grown too large, and for that reason arranged with an investment banking house to distribute part of their holdings of the preferred stock. During the next five years there were frequent transactions in the preferred stock, and by the end of 1934 the transfer books showed 832 stockholders.

In the summer of 1934 one of the preferred stockholders who had accumulated a substantial block of the stock suggested to Mr Tatem, president of the company, that it might be advisable to have the stock listed on one of the exchanges He believed that the company's stockholders would favor listing because it would assure them of securing complete information about the company's activities Daily newspaper quotations would keep the stockholders closely informed concerning the market for the company's stock Furthermore, the spread between bid and ask figures on the exchanges generally was narrower than that in the over-the-counter market. This, he believed, was true because listing meant greater public interest in a stock and therefore more activity. The fact that an over-the-counter dealer's profit usually exceeded the brokerage commission paid on listed shares also tended to spread quotations. Uncertainty often existed concerning the actual market price of a stock dealt in over the counter, since quotations frequently were nominal This stockholder also felt that the federal government would eventually make rules for the over-the-counter market similar to those for registered exchanges, and that in view of this possibility there should be no hesitation to list the company's stocks because of fear of revealing important facts to competitors

This stockholder further pointed out that there would be a ready market for new stock issues if, in the future, the company desired to secure additional capital through sale of stock He felt that possibly added prestige would be gained from listing and that this would aid in the sale of the company's products. Finally, he named several concerns of equal and smaller size that had their stock listed on the New York Stock Exchange

Mr Tatem believed that there would not be enough public interest in the company's stock to warrant listing it on any of the exchanges The records for the past three years showed that on an average only 3,000 shares a year changed hands The listing itself would be no guarantee of activity, and even if it were, the advantages to the company would be insignificant and would hardly balance such expenses as the listing fees, transfer charges, and the cost of reports required by exchanges He maintained that information of value might be disclosed to competitors by means of the numerous reports required Since several small investment dealers specialized in handling the stock, he felt that ample marketability was provided, although the spread between bid and ask figures did tend at times to be wide. Mr Tatem decided, however, to present the problem to the directors He submitted a report to the directors which included the following data·

Information required by stock exchanges:

Statement of full particulars in regard to history and capitalization of the company Statement of terms and provisions of debts, guaranties, leases, traffic agreements, rentals, etc Description of patents Statements of condition, earning statements and balance sheets of recent years certified by independent accountants. Explanation of depreciation policies and reserve policies. Statement of remuneration of officers, directors, and underwriters

Copies of official company documents, charter, by-laws, leases, trust indentures, and resolutions and so forth, to be filed with the exchange Opinion of counsel, legal and not administrative, as to status under National Securities Acts. Information concerning previous trading in security to be listed place, price, and bankers

Description in full of security to be listed

Questionnaire describing further the policies and status of the company to be signed by an officer.

Description of company's operations

Description of present distribution of stock, including persons owning 10% or more of any equity security

Agreements with the exchange to be signed, as follows

To notify the exchange of any change in the character of the business, change in holdings in stock of itself or subsidiary that might change the financial position of the company Change in any collateral deposits. To forward to the exchange stockholders' resolutions concerning charter To give 20 days' notice before the changing of the listed security in any particular To apply for additions to the security

listed Not to purchase treasury stock at premium, and to select preferred stock only pro rata or by lot, and to notify the exchange 15 days previous to such an operation "To furnish the New York Stock Exchange, on demand, such reasonable information as may be required"

To publish a separate balance sheet, income statement, and surplus statement for the individual company at least 15 days prior to the annual meeting, and a clear statement of parent company equity in subsidiaries and separate statements for the subsidiaries Audit for these items to be by independent qualified public accountants, and a statement, if any, of qualifications by the accountant To be consistent and honest in accounting practices To publish periodical statements of earnings (quarterly suggested) Not to pay dividends out of other than earnings or earned surplus

To maintain a transfer office, and register office, separately, in the financial district of New York City, and to notify the committee of any change in offices or fiscal agent. Not to select an officer of the company as a mortgage trustee unless he be a co-trustee for an issue having a corporate trustee To have on hand a supply of certificates fulfilling the exchange's specifications To publish capital setup changes, to notify the exchange in such an instance, and to maintain transfer offices for any additional rights, warrants, etc To publish notice of changes in ample time to allow the stockholders to voice their rights

To make provisions for special agreements, Trustees of Mortgages, Transfer and Registry, and Forms of Certificates, Engraving, etc

Fees for listing on the New York Stock Exchange are $120 per 10,000 shares or fraction thereof The exchange drops from its list not only the security of a company which fails to live up to its formal and understood agreements with the exchange, but also any security in which there does not seem to be sufficient trading in a free market to justify the listing The exchange points to the dangers of cornering as well as the bad economy in such a situation

The Securities Exchange Act of 1934 forbade the unfair use of special information available to such persons as company directors and officers If a profit were made through sale or purchase of securities based on this information, suit could be brought and the amount paid to the company

The following excerpt from the Securities Exchange Act of 1934 was also included by the president in the material submitted to his directors.

Sec 12 (*a*) It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is

effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder

(b) application [for registration] shall contain

(1) Such information, in such detail . . . in respect to the following

(A) The organization, financial structure, and nature of the business, (B) the terms, position, rights, and privileges of the different classes of securities outstanding, (C) the terms on which their securities are to be . offered to the public or otherwise, (D) each security holder of record holding more than 10 per centum of any class of stock . , (E) remuneration to others than directors and officers exceeding $20,000 per annum, (F) bonus and profit-sharing arrangements, (G) management and service contracts, (H) options existing or to be created in respect of their securities, (I) balance sheets , (J) profit and loss statements . , (K) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.

The Securities Exchange Act of 1934 required uniform listing of information on every national securities exchange, differences occurring only in measures of local importance to an individual exchange Since the Tatem Company was a New England company, however, several of the company's officers felt that a listing of the company's stock might command more attention on the Boston Stock Exchange than elsewhere. Fees for listing on the Boston Exchange were as follows $500 for 100,000 shares or any part, $2 per 1,000 shares for the succeeding 200,000 shares, and $1 per 1,000 shares for amounts in excess of 300,000 shares Five thousand dollars was the maximum fee. All classes of stock of a given concern were treated as one unit.[1]

In commenting to the directors on the wisdom of listing the company's stock, the president remarked in summary as follows

Trading in the company's stock is not heavy, and should further issuance of stock be made it would be time enough to list on one of the exchanges The company has ceased growing rapidly Whatever expenditures might be attached to the listing would be better applied to sales promotion The advertising possibilities in listing would be negligible when trading in the security is as light as it is bound to be

The fear of releasing private information should not disturb the directors because there is little that is not already available to the public Making the various reports and other data would probably turn out to be expensive and burdensome The use of the stock as collateral is curtailed when the company's stock is not listed on one of the exchanges One company comparable in size to the Tatem Com-

[1] The listing fee would be $680 for the Tatem Company

pany, is considering seriously withdrawing its stock from one of the New York exchanges, because the stock, also closely held, often had a spread between bid and ask of as much as five to eight points

Should the directors of the Tatem Company have favored the listing of the company's stock on one of the exchanges?

SUMMARY QUESTIONS

1 What financial institutions are of outstanding importance to a corporation? Under what conditions?

2 What classes of corporations use the services of factors? Why?

3 Do you favor the trend toward increasing control of our financial institutions by the government?

4 What are the advantages to a corporation in having its securities listed on a security exchange?

READINGS

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APPENDIX I

ANALYSIS OF FINANCIAL STATEMENTS

In order to gain a better understanding of a company's financial position than is obtainable simply from an inspection of its operating statement and balance sheet, certain relationships among items expressed as ratios and in other ways have been found valuable as tools of analysis In working with financial statements and financial ratios it is important to bear in mind their definite limitations In the first place, accounting methods vary greatly Secondly, many values are necessarily based on estimates Furthermore, the stated value of current assets may or may not approximate the market value, while the stated value of fixed assets is usually based on the cost of the original investment but may have been changed for various reasons and may differ decidedly from the current market value

The first step in the analysis of financial statements is to discover relationships among the most significant items on balance sheets and operating statements A ratio is merely a short way of expressing any such relationship For example, a current ratio of 2 to 1, indicating that current assets are twice as large as current liabilities, gives a much clearer picture of a company's position than would a mere statement of current assets without reference to current liabilities, or than would be available from a casual glance at the figures representing current assets and current liabilities on the two sides of the balance sheet A second step is to consider related ratios, in forming one's judgment A current ratio of 2 to 1 or 5 to 1, for instance, may suggest financial strength, but a net-worth-to-debt ratio of 0 5 to 1 for the same company may indicate that there is an inadequate amount of ownership capital in the business. As a third step, this study of relationships should be carried back over a period of years to see whether or not the trends in the ratios show an improvement or a decline in the financial condition of the company, and also to see how the ratios have been affected by different phases of the business cycle. A fourth step is to compare a series of ratios for a company with corresponding figures for the industry

A further step in analysis is to determine how the financial condition of the company as represented by these ratios might be altered in the future by changes in general business, in the industry, and in management policies All data shown on and derived from financial statements are, of course, historical and valuable chiefly in understanding the past condition of a company. A financial analysis of a company

must go further, it must include a consideration of probable future conditions

An additional type of relationship to study in interpreting financial statements is that between the sources and uses of funds For example, an expansion of plant by the use of funds secured on short-term bank-notes may indicate an inappropriate relationship between source and use of funds because recovering the cost of plant from the ordinary sale of products may take years, while the notes may have to be retired in a few months Such a situation may, of course, be justified merely as a temporary expedient if a later procuring of funds from more appropriate sources is anticipated

The following outline explains briefly important ratios In some cases, however, not all of these may be useful, and in other cases entirely different ratios should be devised and computed

RATIO ANALYSIS

A To analyze the current position of a company, the following ratios are commonly used

1 Current Ratio *Current Assets* divided by *Current Liabilities*

The current ratio shows the amount of cash and assets soon to be converted into cash, in relation to liabilities which will soon mature It indicates the amount in dollars which will presumably be available in current assets to meet each dollar of current liabilities

(In thousands of dollars)

Cash	$ 420	Accounts payable	$ 294
Receivables	1,406	Customers' deposits	289
Inventories	3,078	Accruals	61
		Notes, etc	2,904
Current assets	$4,904	Current liabilities	$3,548

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}} = \frac{4{,}904}{3{,}548} = 1\ 38 \text{ to } 1^{1}$$

2. Acid Test. *Current Assets less Inventories* divided by *Current Liabilities*

The acid test indicates how well each dollar of current liabilities is covered by current assets less inventories.[2] It is particularly useful in analyzing industries which carry large inventories, because uncertainties usually exist as to the valuation and rate of conversion of these inventories

(In thousands of dollars)

Current assets	$4,904		
Less Inventories	3,078		
	$1,826	Current liabilities	$3,548

[1] Numerical data from Cleveland Tractor Company case, see p 204

[2] Cash items and accounts receivable divided by current liabilities is also frequently used as the acid test ratio

$$\text{Acid Test} = \frac{\text{current assets less inventories}}{\text{current liabilities}} = \frac{1{,}826}{3{,}548} = .52 \text{ to } 1^{1}$$

3 Receivables Turnover· *Annual Sales* divided by *Receivables*

The receivables turnover indicates roughly the turnover of credits to customers, or the average number of times the amount of accounts receivable has been collected during the year The turnover figure, when divided into 360 days, gives the average number of days necessary to collect from customers, or the so-called collection period If the company sells partly for cash, the computed figure for turnover will be somewhat greater than actual turnover, and the collection period will therefore appear somewhat shorter than it actually is An excessively long collection period or a low turnover suggests that receivables may not be collected in full, the interpretation of the current ratio should take this possibility into account

$$\text{Receivables Turnover} = \frac{\text{sales}}{\text{receivables}} = \frac{12{,}599}{1{,}406} = 8\ 96^{1}$$

4 Collection Period *Receivables times 360* (*days*) divided by *Annual Sales*

This computation is merely a simple way to find the collection period discussed under (3)

$$\text{Collection Period} = \frac{\text{receivables} \times 360}{\text{sales}} = \frac{1{,}406 \times 360}{12{,}599} = 41 \text{ days}^{1}$$

5 Inventory Turnover *Annual Sales* divided by *Inventory*

Inventory turnover indicates roughly how rapidly the inventory is being converted into sales It is based on commonly available figures, and is not to be mistaken for the more precise "turnover" ratio (or stock-turn) used in retail stores, for example.

$$\text{Inventory Turnover} = \frac{\text{sales}}{\text{inventory}} = \frac{12{,}599}{3{,}078} = 4\ 10^{1}$$

B. To analyze the relationship between owned and borrowed funds, the following ratios may be studied

1. *Net Worth* divided by *Total Debt*

This relationship indicates how many dollars of capital have been supplied by the owners for each dollar advanced by others Net Worth customarily represents capital stock and surplus from which such intangible items as goodwill, patents, or organ-

[1] Numerical data from Cleveland Tractor Company case, see pp 204 and 206

ization expenses have been deducted [1] Reserves which are purely segregated surplus are included in the Net Worth Reserves for liabilities, such as taxes, are included in Debt Offset reserves, such as reserves for depreciation and for losses from bad debts, are considered neither as a part of Net Worth nor of Debt but as deductions from the assets to which they apply. The soundness of Net Worth may be tested by the two ratios noted (*a*) and (*b*) below

(In thousands of dollars)

Preferred stock	$ 1,000		Mortgage bonds		$ 8,500
Common stock and surplus	15,424		Debentures		2,500
			Purchase obligations		471
Contingency reserves	662	$17,086	Notes payable		480
			Accounts payable		2,107
			Reserve for taxes		117
Less					
Goodwill	$419		Subsidiary preferred stock	$402	
Treasury stock	106	525	Minority interest in subsidiaries	184	
Net worth		$16,561	Bonds of subsidiaries	773	
			Notes payable of subsidiaries	382	1,741
			Debt		$15,916

$$\text{Net Worth to Debt} = \frac{\text{net worth}}{\text{debt}} = \frac{16{,}591}{15{,}916} - 1\ 04 \text{ to } 1$$ [2]

(*a*) *Annual Sales* divided by *Net Worth*

This computation shows the turnover of the indicated investment of the owners If this ratio is consistently lower than for similar companies, it probably indicates that the management is relatively inefficient or that Net Worth does not represent sound value

$$\text{Sales to Net Worth} = \frac{\text{sales}}{\text{net worth}} = \frac{12{,}599}{4{,}961} = 2\ 54 \text{ to } 1$$ [3]

(*b*) *Net Worth* divided by *Fixed Assets*

This ratio is helpful in determining whether or not the owners have invested the equivalent of the value of the fixed assets It is especially significant when credit is being advanced to a company supposedly only to supply working capital

[1] This ratio is little affected by the deduction of small items, and meticulous examination of a complicated balance sheet for such items is usually a waste of time When the goodwill items are large, two ratios are often computed, one omitting and the other including such items

[2] Numerical data from Johnson Brothers case, see p 163

[3] Numerical data from Cleveland Tractor Company case, see pp 204 and 206

$$\text{Net Worth to Fixed Assets} = \frac{\text{net worth}}{\text{fixed assets}} = \frac{4{,}961}{3{,}100} = 1\ 60 \text{ to } 1^1$$

C To analyze reported profits the following ratios are useful

1 *Annual Net Profit* divided by *Net Worth* (expressed as a percentage)

Sustained high return on investment indicates profitability of enterprise and probably soundness of Net Worth Continued low return may indicate ineffective management, overcapitalization, or overstatement of assets

$$\text{Net Profit on Net Worth} = \frac{\text{net profit} \times 100}{\text{net worth}} = \frac{300 \times 100}{4{,}961} = 6\%^1$$

2 *Annual Net Profit* divided by *Annual Sales* (expressed as a percentage)

The efficiency of operation is indicated without raising question as to the soundness of the Net Worth figure

$$\text{Net Profit on Sales} = \frac{\text{net profit} \times 100}{\text{sales}} = \frac{300 \times 100}{12{,}599} = 2\ 4\%^1$$

D. To analyze the adequacy of earnings to meet creditor and ownership claims in the capital structure, the following computations may be made

1 *Number of Times Charges Are Earned*

The changes in the number of times charges on borrowed capital and on preferred stocks have been earned are especially significant in judging the suitability of the company's financial structure in relation to its earnings The effect of business cycles and the general trend in these ratios should be particularly noticed and the ratios compared with similar ratios for other companies in the industry

(*a*) *Net Income*[2] divided by *Mortgage Bond Interest Requirements*

The result of this computation serves to indicate how well the interest claims of senior liens have been covered

Rentals		$ 41,953
Interest on all funded debt	$12,803,367	
Less Estimated interest on debentures and income bonds	3,657,053	
Estimated fixed interest on mortgage bonds		9,146,314
Senior interest requirements		$ 9,188,267
Net income		$20,179,851

[1] Numerical data from Cleveland Tractor Company case, see pp 204 and 206

[2] After depreciation and income taxes but before interest charges

Times Fixed Mortgage Bond Interest Earned =

$$\frac{\text{net income}}{\text{interest charges}} = \frac{20{,}179{,}851}{9{,}188{,}267} = 2.2^{1}$$

(*b*) *Net Income*[2] divided by *All Interest Requirements*

This ratio will reveal how well the interest on both prior secured claims and the unsecured claims of debenture holders, banks, and other creditors, have been met

Rentals	$ 41,953
Interest on all funded debt	12,803,367
Interest on unfunded debt	125,972
Other income deductions	207,245
All interest requirements	$13,178,537
Net income	$20,179,851

$$\text{Times All Interest Earned} = \frac{\text{net income}}{\text{all interest}} = \frac{20{,}179{,}851}{13{,}178{,}537} = 1.53^{3}$$

(*c*) *Net Income*[2] divided by *All Interest and Preferred Dividend Requirements*

This ratio shows how the company has met all charges arising from its capital structure on an "over-all" basis, thus reflecting the suitability of its capital structure to earnings possibilities

All interest requirements	$13,178,537
Preferred dividend requirements	6,208,540
Total charges	$19,387,077

Times All Interest and Preferred Dividends Earned =

$$\frac{\text{net income}}{\text{total charges}} = \frac{20{,}179{,}851}{19{,}387{,}077} = 1.04^{3}$$

2 *Earnings per share of Capital Stock*

(*a*) Per share of Preferred *Net Earnings Available for Dividends* divided by *Number of Preferred Shares Outstanding*

This figure, compared with the preferred dividend rate over a period of years, is another criterion of the income security and appropriateness of the preferred stock issue in a company's capital structure

Earnings per share of Preferred Stock =

$$\frac{\text{available for preferred}}{\text{number of preferred shares}} = \frac{\$7{,}001{,}314}{1{,}241{,}728} = \$5.64^{3}$$

[1] Numerical data from Atchison, Topeka and Santa Fe Railway Company case, see pp 33 and 34

[2] After depreciation and income taxes but before interest charges

[3] Numerical data from Atchison, Topeka and Santa Fe Railway Company case, see pp 32 and 33

(*b*) Per share of Common *Net Earnings Available for Dividends minus Preferred Dividend Requirements* divided by *Number of Common Shares Outstanding*

A history of the return on each ownership share is a further index of the profitability of the company's operations and the soundness of its financial structure

Net profit	$7,001,314
Less Preferred dividend requirements	6,208,640
Available for common dividends	$ 792,674

Earnings per share of Common Stock =

$$\frac{\text{available for common}}{\text{number of common shares}} = \frac{\$792{,}674}{2{,}427{,}060} = \$0\ 32$$ [1]

E. To analyze capital structure, the following percentages are often helpful

1. Capital Ratios *Each Item in the Capital Structure*, respectively, divided by the *Total Capitalization* (expressed as a percentage)

List items and amounts in the permanent capital structure of the corporation, deducting goodwill and other intangible assets from surplus Express each amount as a percentage of the total These percentages are the capital ratios, they show the proportion of the long-term capital furnished by various classes of creditor and ownership claims.

Capital structure	Amount	Percentage of total capitalization
Mortgage bonds	$ 273,087,762	25 6
Debentures	36,572,500	3 4
Preferred stock	124,172,800	11 6
Common stock	242,706,000	22 7
Surplus	392,190,871	36 7
Total capitalization	$1,068,729,933*	100 0

* Numerical data from Atchison, Topeka and Santa Fe Railway Company case, see p 36

F To check valuations the following measures are useful

The value of a company depends roughly upon its outlook for earnings, upon the business risks involved, and upon the probable level of interest rates. The value of the common stock equity sometimes is estimated by multiplying the number of shares of

[1] Numerical data from Atchison, Topeka and Santa Fe Railway Company case, see pp 32 and 33

common stock outstanding by the market price per share, or by capitalizing earnings, or by considering the net worth as indicated on the company's books It should be remembered, however, that the sale of a business is a matter of negotiation, the following estimates are merely aids in setting bargaining limits.

1. Market Value *Number of Outstanding Shares of Common Stock* multiplied by *Market Price per Share*

   This computation gives a very rough approximation of the value of the common stock equity of a company as appraised by the security markets. This method is applicable only for companies with actively traded securities Even in such cases the price of the few shares traded daily probably has little relation proportionally to the total value

2 Capitalization of Earnings *Annual Net Earnings* multiplied by *Capitalizing Factor*, or *Annual Net Earnings* divided by *Capitalizing Rate*

   When there is no broad market for the common stock, one rule-of-thumb method for estimating the value of a company is to multiply the average annual earnings for a period of years by a "capitalizing factor" The estimate of a proper capitalizing factor is commonly begun by studying the ratio of *common stock prices to earnings per share* for comparable companies over the course of a business cycle One should adjust these factors for the peculiar advantages or disadvantages of the company being appraised This adjusted capitalizing factor is then an initial approximation to the number of average year's earnings which the company is worth

   Another way of relating value to earnings is to determine the rate of return one would want before investing in that company This rate is called the "capitalizing rate" The value of the company would then be placed at an amount equal to that investment which would yield an average year's earnings at the desired rate of return The estimate of a proper capitalizing rate should be begun by considering the rate of return on investment which would be commensurate with the risks of the given company in comparison with the rate of return for comparable companies as indicated by their ratio of *earnings per share to common stock price* Another consideration is that the rate should be enough greater than the yield of high-grade bonds to compensate for the greater risk This adjusted estimate of the capitalizing rate represents the probable average year's earnings as a percentage of the value of the company Consequently to find the value of the company, divide the estimated earnings by the desired rate of return

   The following example illustrates how to compute the capitalizing rate or factor

Company	Average annual earnings per share 1919–1924	Approximate price per common share June 30, 1925	"Capitalizing factor" (price ÷ earnings)	"Capitalizing rate" (earnings ÷ price)
Allis-Chalmers Manufacturing Company	$ 6	$ 81	13	7%
Ingersoll-Rand Company	23	260	11	9%
Yale & Towne Manufacturing Company	8	66	8	12%
Walworth Manufacturing Company	3	17	6	18%

Executives of the Walworth Manufacturing Company, when they were considering the purchase of the Kelly and Jones Company, made the following estimates

Annual average earnings = $900,000
Capitalizing rate = 12%
Capitalizing factor = $8\frac{1}{3}$

Estimated Value of Company =

$$\frac{\text{estimated future earnings}}{\text{capitalizing rate}} = \frac{\$900{,}000}{12} = \$7{,}500{,}000$$

Also, Estimated Value of Company = estimated future earnings × capitalizing factor = $900,000 × $8\frac{1}{3}$ = $7,500,000[1]

3. Book Value

The book value of the common stock equity is the value of the net worth (total value of capital stocks, surplus, and surplus reserves, less value of goodwill) less the value of the preferred

Company	Earnings per common share, 1934	Price ÷ earnings ratio	Market price per common share, Dec 31, 1934	Book value per common share, Dec 31, 1934	Book value as percentage of market price, Dec 31, 1934
Consolidated Gas, Electric Light and Power Company of Baltimore	$4	13	$53	$43	81%
Lambert Company	3	9	27	9	33%

[1] Numerical data from Walworth Company (I) case, see pp 239 and 240

stock. Book values per share may have little relation to market values, but sometimes they are of use in studying the relative importance of tangible and intangible elements in stock values

(*a*) Book Value per Share of Preferred *Net Worth* divided by *Number of Preferred Shares Outstanding*

Preferred stock	$124,172,800
Common stock	242,706,000
Surplus	392,190,871
Net worth	$759,069,671
Number of preferred shares	1,241,728

Book Value per Share of Preferred Stock =

$$\frac{\text{net worth}}{\text{number of preferred shares}} = \frac{\$759{,}069{,}671}{1{,}241{,}728} = \$611^{1}$$

(*b*) Book Value per Share of Common *Net Worth Minus Liquidation Claims of Preferred Stock* divided by *Number of Common Shares*

Preferred shares are often entitled to a premium in case of liquidation, consequently the liquidation value of the preferred shares should be used in figuring the book value of common shares.

Net worth	$759,069,671
Less Value of preferred shares, entitled to par on liquidation	124,172,800
Book value for common shares	$634,896,871
Number of common shares	2,427,060

Book Value per Share of Common Stock =

$$\frac{\text{book value available}}{\text{number of common shares}} = \frac{\$634{,}896{,}871}{2{,}427{,}060} = \$261^{1}$$

It must constantly be borne in mind, however, in considering any basis for determining value, that value is the result of subjective judgment Value is not an extrinsic quality Hence, no formula will serve adequately as a determinant Formulas such as those discussed above produce interesting evidence to be considered in the weighing of the specific elements of value in a given situation, but that is all The final determinant of value is the negotiation of the various interested parties in a given transaction,

[1] Numerical data from Atchison, Topeka and Santa Fe Railway Company case, see p 32

in which bargaining power and human judgments play the dominating role

SOURCES AND USES OF FUNDS

Evidence of the source and use of funds should be obtained by comparing balance sheets reflecting the company's position just before and just after any major changes in its financial status [1]

1 Increases in liability items indicate the sources from which funds have been secured For example, an increase in Notes Payable usually indicates that more funds have been borrowed from banks, an increase in Surplus, with possible qualifications, indicates that funds have been secured from earnings

2 Increases in asset items or decreases in liability items indicate where funds have been used For example, an increase in Inventories indicates that funds have been used to buy or process more goods, a reduction in Accounts Payable indicates that funds have been used to pay off trade creditors

3 Decreases in asset items indicate that the items have been partially liquidated and the funds used elsewhere, or, possibly, that the values have been written down For example, a decrease in Accounts Receivable probably indicates that they have been collected and the funds shifted to other uses

(In millions of dollars)

Major balance sheet items‡	Dec 31, 1930	Dec 31, 1931	Source of funds	Use of funds
ASSETS				
Receivables, net	$1 4	$ 8	$ 6*	
Inventories	5 1	8 0		$2 9†
Growing Crops	3 3	2 6	7*	
Fixed Assets, net	9 8	10 9		1 1†
LIABILITIES				
Accounts Payable	8	4		4*
Due Customers		6	6†	
Notes Payable	1 8	4 5	2 7†	
Accrued Taxes	5			5*
5% notes of 1936		5 0	5 0†	
Earned Surplus	6 5	1 5		5 0*
Minor changes, net			3	
Total			$9 9	$9 9

* Decrease
† Increase
‡ Numerical data from Hawaiian Pineapple Company, Ltd, and California Packing Corporation case see p 125

[1] The analysis described here is only for the purpose of interpreting balance sheets quickly A complete discussion of Source and Application of Funds statements will be found in the references given in the reading list

READINGS

BADGER, R E *Investment Principles and Practices* New York Prentice-Hall, Inc , 1930 "Capital Ratios," pp 304–306 (Covering especially Section E)

COUCHMAN, C B *The Balance Sheet* New York Journal of Accountancy, Inc , 1924 Chap III "Elements of a Balance Sheet," pp 28–38

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WALL, ALEXANDER, and DUNNING, R W *Ratio Analysis of Financial Statements* New York Harper & Brothers, 1928 Chap VII "The Static Ratios," pp 107–127, Chap VIII "The Dynamic Ratios," pp 128–140, Chap IX "Supplementary Ratios," pp 141–151 (Covering especially Sections A, B, and C)

APPENDIX II

SECURITIES AND EXCHANGE COMMISSION[1]

On July 6, 1934, the Securities and Exchange Commission was organized to administer the Securities Exchange Act of 1934, approved by Congress on June 6. Administration of the Securities Act of 1933 (formerly a function of the Federal Trade Commission) and of the Public Utility Act of 1935 is also to be carried on by the Securities and Exchange Commission

The five members of the commission, not more than three of whom are permitted to be members of the same political party, are appointed by the President, by and with the advice and consent of the Senate, for a term of 5 years The terms are arranged so that a vacancy occurs each year The functions of the commission may be classified under the following headings "the supervision of registration of security issues and the suppression of fraudulent practices in the sale of securities under the Securities Act of 1933, the supervision and regulation of transactions and trading in securities, both on the stock exchanges and in the over-the-counter markets, as provided by the Securities Exchange Act of 1934, and the regulation of public utility holding companies as provided in the Public Utility Act of 1935"

The Securities Act of 1933 gives the commission power to compel a complete and fair disclosure to investors of all relevant facts regarding securities publicly offered and sold in interstate commerce or through the mails and to prevent fraud in the sale of securities Registration statements covering securities to be sold are filed on forms, requiring certain information, financial statements and exhibits, including the form of the prospectus proposed for use in selling the security The prospectus describing the issue must be given to each prospective purchaser before any sale is made through the mails or in interstate commerce

The purpose of the Securities Exchange Act of 1934 is the elimination of abuses in the securities markets and the issuance of sufficient information concerning the management and financial condition of the corporations whose securities are traded in the securities markets to enable the investor to act intelligently in making or retaining his investments and in exercising his rights as a security holder The regulation of securities transactions has been brought under the supervision of the commission by registration or specific exemption Reports, which are filed with and published by the commission, describe

[1] U S National Emergency Council, *U S Government Manual*, Washington, D.C, June 1, 1936

the transactions of officers, directors, and principal stockholders in the shares of their listed companies The Board of Governors of the Federal Reserve System regulates the amount of margin extended to each customer and the character of loans to brokers and dealers, who, with few exceptions, can borrow only from members of the Federal Reserve System or banks under the jurisdiction of the Board of Governors of the Federal Reserve System

The Public Utility Holding Company Act of 1935, which applies only to electric and gas systems, defines the duties of the commission as the "elimination of uneconomic holding company structures, supervision of security transactions by holding companies and subsidiaries, supervision of acquisitions of securities, utility assets, and other interests by holding companies and their subsidiaries, and supervision of dividends, proxies, intercompany loans, and service, sales, and construction contracts" The purpose of the act is to give investors and consumers in the public utility field greater protection by disclosing the corporate structure of holding company systems

The commission is given power to deny, suspend, or revoke registrations of securities and security exchanges It may institute injunctive proceedings against violators of these laws, all of which provide civil liabilities and criminal penalties for violations, as well as exercise the power of subpoena and investigation These laws do not guarantee investors against loss. The commission has certain powers to control issuance of securities by public utility holding companies and their subsidiaries, but can merely require the disclosure of complete information regarding other securities.

APPENDIX III

RECONSTRUCTION FINANCE CORPORATION[1]

The Reconstruction Finance Corporation was organized on February 2, 1932, and will be in existence for 10 years from January 22, 1932, unless dissolved earlier by Congressional action The corporation was established to "provide emergency financing facilities for financial institutions, to aid in financing agriculture, commerce, and industry; to purchase preferred stock, capital notes, or debentures of banks, trust companies, and insurance companies, and to make loans and the allocation of its funds as prescribed by law "

The board of directors consists of the Secretary of the Treasury, *ex officio*, and six men appointed by the President, by and with the advice and consent of the Senate The corporation has an executive committee composed of the chairman and two other members of its board of directors

The capital stock of $500,000,000 was fully subscribed and paid in by the Secretary of the Treasury On January 31, 1935, the corporation was authorized to use as general funds all receipts arising from the sale or retirement of any of the stock, notes, bonds, or other securities acquired by it pursuant to any provision of law At any one time the corporation may issue and have outstanding $3,750,000,000 plus the following

1 an amount not to exceed $125,000,000 to permit the Secretary of the Treasury to make payments for subscriptions for capital stock of the Federal Home Loan Bank;

2 whatever amounts may be necessary to subscribe for preferred stock of national or state banks or trust companies, to make loans secured by such stock as collateral, and to purchase capital notes or debentures of state banks or trust companies, to make loans to the Secretary of Agriculture on the security of cotton, to provide funds to the Federal Housing Administrator to enable him to carry out the provisions of Titles I, II, and III of the National Housing Act,

3 a sum not to exceed $75,000,000 to subscribe for preferred stock, to purchase capital notes of insurance companies, and to make loans secured by such stock or notes as collateral,

4 a sum of $500,000,000 to enable the Federal Emergency Relief Administrator to make relief and work relief grants to states and territories and the District of Columbia;

[1] U S National Emergency Council, *U S Government Manual*, Washington, D C, May 1, 1936

5 the sum of $300,000,000 to enable the Land Bank Commissioner to make loans to joint-stock land banks and to farmers,

6 an amount not over $200,000,000 to permit the Secretary of the Treasury to make payments for subscriptions for the capital stock of the Home Owners' Loan Corporation,

7 an amount not over $250,000,000 at one time to purchase at par value the debentures and other obligations of the Federal Deposit Insurance Corporation,

8 an amount not over $250,000,000 at any one time for the purchase of marketable securities acquired or to be acquired by the Federal Emergency Administration of Public Works,

9 a sum not to exceed at any one time $100,000,000 to subscribe for and make loans upon nonassessable stock of any national mortgage association organized under Title III of the National Housing Act and of any mortgage loan company, trust company, savings and loan association, or other similar institution, and to purchase capital notes or debentures of such financial institutions

The corporation may make loans or advances to the following institutions, associations, and persons, or for the purposes following

FINANCIAL INSTITUTIONS

Upon full and adequate security subject to terms and conditions set forth in the law, the corporation may lend to any bank, savings bank, trust company, building and loan association, insurance company, mortgage loan company, credit union, Federal land bank, joint-stock land bank, Federal intermediate credit bank, agricultural credit corporation, or livestock credit corporation, and may also make loans secured by the assets of any bank, savings bank, or building and loan association that is closed or being liquidated in order to aid in the reorganization or liquidation

RAILROADS

To assist in the financing, reorganization, consolidation, maintenance, or construction of any railroad engaged in interstate commerce the corporation may, with the approval of the Interstate Commerce Commission, purchase the obligations of the railroad, including equipment trust certificates, or guarantee the payment of the principal or interest on such obligations When funds are not available from private sources, furthermore, the corporation may make loans upon full and adequate security to such railroads or to receivers or their trustees for the purposes set forth In the case of loans to or the purchase or guarantee of obligations, including equipment trust certificates, of railroads not in receivership or trusteeship (except in the case of loans made for the maintenance of or purchase of equipment for such railroads), the Interstate Commerce Commission must certify that the railroad on the basis of present and prospective earnings may be expected to meet its fixed charges without a reduction through

judicial reorganization. Total loans for these purposes may not exceed $350,000,000 at any one time, in addition to loans or renewals of loans made before January 31, 1935

If the obligations purchased or loans made mature later than 5 years from date of purchase or date granted, the corporation may require arrangements for the reduction or amortization of the indebtedness in whole or in part, subject to the approval of the corporation and of the Interstate Commerce Commission

If any officer, director, or employee of the applicant is receiving a compensation which seems to be excessive, the corporation may not make, renew, or extend any loan The applicant must also agree not to increase the compensation of its officers, directors, or employees to an amount which to the corporation appears excessive

At no time may the total advances to any one corporation or its subsidiaries or affiliates exceed 2⅝% of the authorized capital stock of the Reconstruction Finance Corporation plus the total amount of bonds authorized to be outstanding when the capital stock is fully subscribed These limitations do not apply in the case of advances made for liquidation or reorganization to receivers or liquidating agents of closed banks.

NATIONAL AND STATE BANKS AND TRUST COMPANIES

The Reconstruction Finance Corporation may subscribe for preferred stock, exempt from double liability, of any national bank, state bank, or trust company and make loans upon such security If preferred stock exempt from double liability is not permitted by law, or if such issue is permitted only by unanimous consent of stockholders, the corporation may purchase capital notes or debentures of such state bank or trust company Purchases of preferred stock, capital notes, or debentures and loans upon preferred stock are made upon the request of the Secretary of the Treasury, with the approval of the President.

INSURANCE COMPANIES

The corporation may subscribe for preferred stock of any class, exempt from assessment or additional liability, in any insurance company which needs funds for capital purposes and may make loans secured by such stock If the insurance company is not permitted to issue preferred stock exempt from assessment or additional liability, or is permitted to issue it only with the unanimous consent of its directors or upon notice of 20 days, or if the company is a mutual organization without capital stock, the corporation may purchase its capital notes or other forms of indebtedness and make loans secured by such notes All purchases of and loans secured by such stock or notes are likewise made upon the request of the Secretary of the Treasury, with the approval of the President No loan may be made if any director, officer, or employee receives total compensation in excess of

$17,500 or unless the applicant agrees not to increase the compensation of any director, officer, or employee to a sum in excess of $17,500 The corporation may not at any one time hold more than $75,000,000 in loans, preferred stock subscribed for or capital notes, or other forms of indebtedness

NATIONAL MORTGAGE ASSOCIATIONS, MORTGAGE LOAN COMPANIES, TRUST COMPANIES, SAVINGS AND LOAN ASSOCIATIONS AND OTHER SIMILAR FINANCIAL INSTITUTIONS

The corporation may subscribe for or make loans upon nonassessable stock (or capital notes or debentures, if the institution may not issue nonassessable stock) of any class of any national mortgage association organized under Title III of the National Housing Act, of any mortgage loan company, trust company, savings and loan association, or similar financial institutions which make loans upon mortgages, deeds of trust, or other instruments conveying or constituting a lien upon real estate or any interest therein By law the corporation is not permitted to have in excess of $100,000,000 in loans outstanding, nonassessable stock, capital notes, and debentures

INDUSTRIAL OR COMMERCIAL BUSINESSES

To maintain or increase employment of labor the corporation, when credit is not available elsewhere at prevailing bank rates for the type of loan desired, may make loans to any industrial or commercial business, including the fishing industry and any institution financing the sale of electrical, plumbing, and air-conditioning appliances and equipment These loans, secured so as to insure repayment, may be made directly, through another bank or lending institution, or by purchase of participations, and shall mature not later than January 31, 1945 They may be made only when they offer assurance of continued or increased employment of labor, and shall be subject to terms prescribed by the board of directors of the corporation Not over $300,000,000 shall be outstanding at any one time in loans of this type

OTHERS

The corporation is authorized to lend to the following projects: to drainage, levee, or irrigation districts, mutual nonprofit companies, and incorporated water users' associations for the reduction or financing of debts or acquisition of facilities necessary for the proper functioning of the project, to individuals, corporations, and partnerships engaged in mining gold, silver, or tin or in financing the production, storage, handling, packing, processing, carrying, or orderly marketing of fish, to managing agencies of farmers' cooperative mineral-rights pools to defray costs of organization, to public school authorities to reduce or refinance debts incurred for construction, operation, and maintenance of public school facilities, to nonprofit corporations to repair damage caused by catastrophes such as floods, earthquakes, fires, tornadoes,

etc , to institutions organized for the financing of the carrying and orderly marketing of agricultural commodities and livestock, to state insurance funds for compensation to injured or disabled workmen or their dependents, to funds created by any state to insure the repayment of deposits of public money in banks or depositories, to parties to any marketing agreement between the Secretary of Agriculture and processors, producers, or associations of producers, and others engaged in handling agricultural commodities or products thereof in interstate or foreign commerce for the execution of such a marketing agreement, to the Secretary of Agriculture to purchase cotton held by all government agencies except the Federal intermediate credit banks and cotton on which money has been loaned or advanced by the United States, including futures contracts for cotton, or which is held as collateral for loans or advances, to receivers for taxes on farm real estate for tax payments, and to the reclamation fund, upon the request of the Secretary of the Interior, for the completion of projects

The corporation may make loans upon or purchase the assets of closed banks It may accept drafts and bills of exchange drawn upon it, arising from transactions involving the export of agricultural or other products sold or transported for sale to foreign countries and may finance sales of surpluses of agricultural products in foreign countries where such sales cannot be financed normally It may loan $75,000 for the use of a Corporation of Foreign Security Holders, and may purchase marketable securities from the Federal Emergency Administration of Public Works and debentures or other obligations of the Federal Deposit Insurance Corporation

Part of the corporation's funds are allocated to other governmental agencies such as the Land Bank Commissioner, the Federal Housing Administrator, the Secretary of the Treasury, and the Federal Emergency Relief Administration

APPENDIX IV

FARM CREDIT ADMINISTRATION[1]

The Farm Credit Administration system was established to provide a complete and coordinated credit system for agriculture by making available to farmers long-term and short-term credit It also provides credit facilities for farmers' cooperative purchasing and marketing organizations The Farm Credit Administration includes the twelve Federal land banks, the twelve Federal intermediate credit banks, the twelve production credit corporations, one central bank for cooperatives and twelve district banks for cooperatives, and the Federal Farm Mortgage Corporation The twelve regional agricultural credit corporations, which are being liquidated, and the feed- and seed-loan activities of the Department of Agriculture, are under the supervision of the Farm Credit Administration The officers of the Farm Credit Administration are its governor, two deputy governors, and four commissioners

The United States is divided into twelve Federal land bank districts In one city in each district are a Federal land bank, a Federal intermediate credit bank, a production credit corporation, and a bank for cooperatives. All these organizations have the same directors, who also serve as the Council of the Farm Credit Administration to coordinate the activities of these organizations. Each institution, however, has its own officers.

FEDERAL LAND BANKS

The Federal land bank system consists of a Federal land bank in each of the twelve land bank districts. It was established to make long-term loans upon the security of first mortgages on farm lands and to issue farm-loan bonds secured by such mortgages These loans are for the following purposes "to provide for the purchase of land for agricultural uses, for the purchase of equipment, fertilizers, and livestock necessary for the proper and reasonable operation of the mortgaged farm, for providing buildings, and for the improvement of farm land, to liquidate indebtedness of the owner of the mortgaged land incurred for agricultural purposes, or incurred prior to January 1, 1933, and to provide the owner of the mortgaged land with funds for general agricultural uses"

The land banks, generally through national farm-loan associations, make these long-term, amortized loans bearing low interest rates to

[1] U S National Emergency Council, *U S Government Manual*, Washington, D C, Apr 1, 1936

persons who give as security first mortgages on their farms and who agree to repay the loans over a period of from 20 to 30 years in annual or semiannual installments consisting of interest and payments on the principal. Under certain conditions corporations engaged in raising livestock may borrow from the Federal land banks. Loans range from $100 to $50,000 to one borrower, but loans over $25,000 must be approved by the Land Bank Commissioner. The amount loaned may not exceed 50% of the appraised value of the land offered as security, plus 20% of the appraised value of permanent, insured improvements on the land.

For interest payable on installment dates after June 30, 1935, and before July 1, 1936, a maximum rate of 3½% is charged on loans held by the Federal land banks on May 12, 1933, or made by them later through national farm-loan associations, for interest payable on installment dates for a period of 2 years beginning July 1, 1936, the maximum rate is 4%, for all interest payable on installment dates after June 30, 1938, 4% is to be paid. On direct loans from the Federal land banks or the Puerto Rican branch of the Federal Land Bank of Baltimore the interest rate is ½ of 1% above the rates paid in similar periods by borrowers through national farm loan associations.

Fees not in excess of the cost of appraisal, legal investigation, and recording may be charged. In the case of associations, the initial charge may not exceed 1% of the loan applied for.

At the end of 5 years after the loan is granted or on any regular installment date thereafter, the borrower may pay advance installments on principal or the entire principal. Special arrangements may be made for prepayments during the first 5 years.

These loan funds are derived from the sale of consolidated Federal farm-loan bonds to the investing public. The bonds constitute the joint and several obligations of the twelve banks, and are exempt from all Federal, state, municipal, and local taxation. The Federal Farm Mortgage Corporation is authorized to make loanable funds available to the Federal land banks by loaning to them upon the security of these bonds, by purchasing them, or by exchanging bonds of the corporation for them.

The membership of each national farm-loan association, through which Federal land bank loans are generally made, is restricted to borrowers from the Federal land bank. Each borrower purchases stock in the association in an amount equal to 5% of his loan, and this stock, which may be included in the face amount of the loan, is pledged with the association as collateral security. The association endorses and is liable for loans made to members, and the stockholders are subject to double liability on debts incurred on or before June 16, 1933. The association in turn subscribes to an equal amount of stock in the Federal land bank and this stock is held as collateral security by the bank.

Upon full payment of a loan, the bank retires its stock subscribed by the association. The borrower's stock in the association is also

retired, and he receives payment for his stock if the association is able to meet its obligations

Direct loans by the land banks are made only in localities where there are no national farm-loan associations In such cases 5% of the loan is subscribed to the stock of the banks by the borrower, and upon repayment this stock is canceled at par or, if impaired, at its estimated value and paid to the borrower Direct borrowers may, subject to certain provisions, form associations and thereby receive a reduction of ½ of 1% in interest rate

LAND BANK COMMISSIONER

The Land Bank Commissioner is authorized to make loans of an emergency character through the land banks These loans are made for the same purposes as the land bank loans and also to refinance any secured or unsecured indebtedness of the farmer or any indebtedness which is secured by a lien on all or any part of the farm property accepted as security for the loan In addition to the $200,000,000 made available for this purpose, the Land Bank Commissioner may use until February 1, 1940, as much as necessary of the assets of the Federal Farm Mortgage Corporation

A farmer may obtain a first-mortgage land bank loan and a second-mortgage Commissioner's loan The security for a Commissioner's loan may be either a first or a second mortgage, and it may be supplemented by a mortgage on farm chattels, such as livestock, equipment, and crops The loan cannot exceed $7,500, nor in addition to prior debts secured by the farm property covered by the mortgage securing the Commissioner's loan can it exceed 75% of the appraised normal value of the property Interest is charged at the rate of 5% a year

The loans are to be repaid annually or semiannually over an agreed period of not more than 43 years in the case of first-mortgage or second-mortgage loans secured wholly by real property and in all other instances within a specified period not to exceed 13 years No principal payments must be paid during the first 3 years of a loan, if the borrower is not in default with respect to other provisions of his mortgage, at the end of 3 years, however, equal amortization payments on the principal must be made in an amount sufficient to repay the mortgage by the termination date

In the case of loans secured by second mortgages, the holder of the first mortgage must sign a forbearance agreement It is sometimes necessary for a farmer to get his creditors to scale down his debts so that he may have a 25% clear equity in the property. Such action, however, must be voluntary

FEDERAL INTERMEDIATE CREDIT BANKS

The twelve Federal intermediate credit banks do not make direct loans to farmers and stockmen for production or marketing purposes but make loans to, and discount paper for, production credit associations,

banks for cooperatives, state and national banks, agricultural credit corporations, livestock loan companies, and cooperative associations of agricultural producers To be eligible for discount or use as collateral for a loan the proceeds of the original loan must be used for agricultural purposes or for raising, breeding, fattening, or marketing livestock The notes must also mature when the crop or livestock is to be marketed—usually within 6 months or 1 year, but by no means over 3 years from date discounted or accepted by the intermediate credit bank

Discount rates may not exceed by more than 1% the interest rate of the latest debentures issued or participated in by the intermediate credit banks unless specifically approved by the Governor of the Farm Credit Administration, and no paper upon which a rate 3% in excess of the rate of the intermediate credit bank was charged by the original lending institution is eligible for discount or as collateral for a loan from the intermediate credit bank

The twelve Federal intermediate credit banks have a paid-in capital of $70,000,000, a paid-in surplus of $30,000,000, and earned surplus of $5,961,782 97 on December 31, 1935 They may also obtain funds for lending purposes through the sale of short-term collateral trust debentures secured by cash and notes or other obligations representing their loans and discounts The farm-loan registrar of the district holds the collateral for the debentures issued by each intermediate credit bank

In addition to a complete report on its financial condition and operations, a financial institution desiring credit from an intermediate credit bank must pledge as additional collateral a substantial portion of its paid-in capital, usually United States government bonds or other approved securities Obviously, the paper offered for discount or as collateral for a loan must be acceptable from a credit standpoint

Loans may be made to cooperative marketing associations on the security of warehouse receipts or shipping documents, but the loan cannot exceed 75% of the market value of the pledged commodities An investigation of the financial condition, management, record of operations, character and condition of collateral offered is the determining factor in granting a loan Loans may also be made to cooperative associations of agricultural producers engaged in purchasing, testing, grading, or processing farm supplies for their members and may be secured by warehousable products or collateral approved by the Governor of the Farm Credit Administration.

PRODUCTION CREDIT CORPORATIONS AND ASSOCIATIONS

The production credit system was organized to furnish short-term credit for general agricultural purposes—for production and marketing of crops and livestock, for the alteration, repair, and improvement of farm equipment and buildings, and the refinancing of indebtedness incurred for agricultural purposes This system is permanent and will ultimately be owned, controlled, and operated by the farmer members

In each land bank district a production credit corporation supervises the lending policies of the production credit associations, and because of its ownership of stock in the associations, the election and appointment of directors and employees are also subject to its approval

The district production credit corporation subscribes to the Class A stock of the association an amount estimated to be 20% of the loans to be made by the association This stock is nonvoting and is preferred only as to assets in case of liquidation Each borrower subscribes five dollars for the Class B stock of the association for every $100 or fraction thereof borrowed. This entitles the borrower to one vote at the association meetings The association's capital is not loaned to farmers but invested in bonds deposited with the Federal intermediate credit bank of the district as additional security for borrowers' notes which the association discounts at the bank The association is permitted to discount notes up to approximately five times its unimpaired capital and guaranty fund.

To receive a loan from an association, the farmer must first offer adequate security Primary security generally must be a first-mortgage lien on personal property, livestock, implements, and crops Real estate liens, if taken, are a secondary security Secondly, he must provide a plan for repaying the loan Most of the loans are short-term loans for less than one year, are of a self-liquidating character, and will mature at the time the crop or livestock is expected to be marketed A renewal is possible if security and other credit factors are satisfactory Thirdly, he must submit a financial statement Fourthly, he must buy Class B stock in the Association Fifthly, he must pay reasonable inspection charges and other necessary expenses incurred

The interest rate is variable since the production credit associations may charge a rate not more than 3% above the discount rate of the Federal intermediate credit banks at the time the loan is made The spread of 3% between the rate paid to the intermediate credit bank by the association and that paid by the borrower goes to the association for operating expenses, for reserves, for a removal of any impairment in capital, for a guaranty fund equal to 25% of its stock and for dividends The present (February 15, 1936) maximum rate in the United States is 5% and in Puerto Rico, 5½%

No loan may be made for less than $50 nor exceed 20% of the combined capital and guaranty fund of the association unless the production credit corporation and the Federal intermediate credit bank approve the collateral, in which case a loan not in excess of 50% of the combined capital and guaranty fund of the association may be made In excess of this limitation the Production Credit Commissioner must approve the loan.

BANKS FOR COOPERATIVES

The Central Bank for Cooperatives and the twelve regional banks for cooperatives grant loans to national, regional, and local farmers'

cooperative organizations Commodity loans, secured by such commodities, are made for financing the handling of the readily marketable commodities, operating loans and effective merchandising loans assist in the effective merchandising of agricultural commodities and their food products and the financing of the operations of the cooperatives, physical facility loans are made for the construction or acquisition of physical facilities for the preparing, handling, storing, processing, or merchandising of agricultural commodities, their food products, or farm supplies

The capital needed to establish the banks for cooperatives was obtained from the revolving fund created under the Agricultural Marketing Act, and the required capital for any one bank depends on the needs of the cooperatives in its district Except for loans secured by commodities the borrowing association must buy $100 worth of stock for each $2,000 or fraction thereof borrowed For commodity-secured loans the amount of stock required is determined by the rules and regulations of the Governor of the Farm Credit Administration The association is paid the fair book value, not in excess of the purchase price, upon repayment of the loan, and the stock is retired and canceled. Stock subscriptions may be included in the loan if the cooperative lacks funds to pay for it If the cooperative is not permitted by law to subscribe for or hold stock in a bank for cooperatives, it must pay into a guaranty fund or the bank may withhold from the loan, an amount equal to the amount of stock which it would otherwise be required to hold Subscribers to the guaranty fund are entitled to dividends at the same rate as subscribers to stock in the bank for cooperatives and the guaranty fund payment is retired in the same manner as stock

In the case of loans secured by commodities, a regional bank may extend credit equal to 20% of its capital and surplus, other loans are limited to 10% of the capital and surplus of the bank, the total of all loans made to one borrower may not exceed 20% of the bank's capital and surplus Upon the approval of the Cooperative Bank Commissioner in exceptional cases these limitations may be disregarded Cooperative associations of national and regional scope, requiring more capital than the regional banks are permitted to lend, may borrow through the Central Bank for Cooperatives

The interest rate on these loans may not exceed 6%, it varies, however, from time to time, and on April 1, 1936, was 4% for physical facility loans, 2% for commodity loans, and 3% for all other loans The maturity date is determined by the circumstances surrounding each loan In general, physical facility loans must be repaid within 5 or 10 years, although 20 years is the time fixed by the law.

FEDERAL FARM MORTGAGE CORPORATION

The Federal Farm Mortgage Corporation assists in financing the lending operations of the Federal land banks and the Land Bank Commissioner It is authorized to issue, and have outstanding, a total

of not more than $2,000,000,000 of bonds. The corporation is capitalized at $200,000,000. Consolidated bonds of the Federal land banks exchanged for the corporation's bonds and the farm mortgages accepted by the Land Bank Commissioner are included in its resources. Payment of principal and interest on the bonds of the Federal Farm Mortgage Corporation is fully and unconditionally guaranteed by the government, and the assets of the corporation will be available for their payment. The bonds are readily marketable as United States government bonds and are lawful security for fifteen-day borrowings by members of the Federal Reserve System and lawful investments for funds, the deposit or investment of which is under the authority or control of the government.

The first issue of the Federal Mortgage Corporation bonds bears interest at the rate of 3¼% a year, payable semiannually, the second and third issues bear interest at the rates of 3% and 2¾% a year respectively. Except for surtaxes, estate, inheritance, and gift taxes, the bonds and the income derived from them are tax exempt. The bonds may be registered or in coupon form.

FEDERAL CREDIT UNION SYSTEMS

The Farm Credit Administration supervises the Federal credit union system, a group of cooperative thrift and lending organizations. The membership is limited to those having common bonds of occupation or association or living within a well-defined community. A member must purchase one or more five-dollar shares of capital stock, and loans are made only to members for provident or protective purposes. No stock is subscribed by the government, nor does it provide any of their loanable funds.

REGIONAL AGRICULTURAL CREDIT CORPORATIONS

Regional agricultural credit corporations were established in each of the twelve land bank districts to make direct loans to farmers and stockmen for agricultural purposes, or for raising, fattening, or marketing of livestock. They are being liquidated as, under the Farm Credit Act of 1933, production credit corporations and associations assume their functions.

EMERGENCY CROP AND FEED LOANS

Farmers without security acceptable to local production credit associations may receive emergency crop and feed loans during 1936 from a $30,000,000 appropriation granted by Congress for the production and harvesting of crops and for feed for livestock.

APPENDIX V

FEDERAL RESERVE SYSTEM[1]

The Federal Reserve System, established on December 23, 1913, "to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes," consists of the supervisory Board of Governors of the Federal Reserve System, the Federal Advisory Council, the twelve Federal Reserve banks, the Federal Open Market Committee, and the member banks, which include all national banks and those state banks and trust companies admitted to the system as a result of voluntary application.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

The Board of Governors of the Federal Reserve System was formerly composed of the Secretary of the Treasury and the Comptroller of the Currency, *ex officio*, and the six members appointed by the President, with the advice and consent of the Senate It now consists of seven members, appointed by the President, by and with the advice and consent of the Senate, and no *ex officio* members These members must represent different interests, and no two members may be from the same Federal Reserve district A semiannual assessment is made upon the Federal Reserve banks, in proportion to their capital stock and surplus, to pay the expenses and salaries incident to the operation of the board

The Board of Governors reviews and determines discount rates charged by the Federal Reserve banks on their discounts and advances Each member of the board is also a member of the Federal Open Market Committee and, with the five other Committee members, representatives elected by the boards of directors of certain Federal Reserve banks, prescribes regulation of open market operations The board has the power within certain limits to change the requirements as to reserves which member banks must maintain against deposits It regulates the amount of credit that may be extended and maintained on most securities registered on a national securities exchange, exercises supervision of the Federal Reserve banks, requiring statements and reports, supervising the issue and retirement of Federal Reserve notes, prescribing the establishment or discontinuance of branches, and super-

[1] U S National Emergency Council, *U S Government Manual*, Washington, D C, May 1, 1936

vising the relationships and transactions of the Federal Reserve banks and foreign banks and bankers within the United States, passes on the admission of state banks and trust companies to membership in the system, limits the interest rate paid by member banks on time and savings deposits, issues voting permits to holding company affiliates of member banks, entitling them to vote the stock of such banks at all meetings of shareholders, acts on applications of national banks to exercise trust powers or to act in fiduciary capacities, issues permits for interlocking directorates between member banks and organizations dealing in securities or, under the provisions of the Clayton Antitrust Act, between member banks and other banks It may remove officers or directors for violation of the law or unsound practices and may suspend member banks from making use of the credit facilities of the system because of misuse of bank credit for speculative purposes or any other unsound practice It exercises control over the establishment of branches by national banks in foreign countries, dependencies, or insular possessions, over the investment in the stock of banks or corporations engaged in international or foreign banking, and over organization and activities of corporations organized under Federal law to engage in international or foreign banking, and it operates a settlement fund through which balances due to and from the various Federal Reserve banks are settled without actual physical transfer of currency.

FEDERAL ADVISORY COUNCIL

The Federal Advisory Council is composed of twelve members, one selected annually by the board of directors of each of the Federal Reserve banks The council meets at least four times a year in Washington and whenever called by the Board of Governors The Council confers with the Board of Governors on general business conditions and makes recommendations concerning general policies and all matters under the jurisdiction of the board.

FEDERAL RESERVE BANKS

The member banks of the Federal Reserve System own the capital stock of the twelve Federal Reserve banks Every national bank must subscribe an amount equal to 6% of its paid-up capital and surplus to the capital stock of the Federal Reserve bank of its district State banks and trust companies, except mutual savings banks, belonging to the system must subscribe a corresponding amount Upon an increase of capital or surplus their subscriptions must be increased in the same proportion A mutual savings bank admitted to membership must subscribe an amount equal to $6/10$ of 1% of its total deposit liabilities, and this subscription must be adjusted semiannually on the same basis Only one-half of the subscription for each member must be fully paid, but the rest is subject to call by the Board of Governors of the Federal Reserve System

After the payment of all necessary expenses, the stockholding member banks are entitled to receive an annual cumulative dividend of 6% on the paid-in capital stock Net earnings, after all expenses and dividend payments have been met, are paid into the surplus fund of the Federal Reserve bank The capital stock, surplus, and income derived from the Federal Reserve banks are exempt from all taxes except taxes on real estate In case of liquidation the surplus, after all payments have been met, reverts to the United States government

The board of directors of each Federal Reserve bank is made up as follows three Class A directors, representatives of the stockholding member banks, three Class B directors, men actively engaged in their district in commercial, agricultural, or some other industrial pursuit, but not officers, directors, or employees of any bank, three Class C directors, who also may not be officers, directors, employees, or stockholders of any bank The six Class A and Class B directors are elected by the stockholding member banks, and the three Class C directors are appointed by the Board of Governors of the Federal Reserve System The term of office is 3 years, and a new director of each class is appointed each year The chairman of the board of directors, who also acts as Federal Reserve agent, and the deputy chairman are selected from Class C The president and the vice president of each Federal Reserve bank are appointed for a term of 5 years subject to the approval of the Board of Governors

Federal Reserve banks may discount for their members notes, drafts, bills of exchange, and bankers' acceptances of short maturities arising from commercial, industrial, or agricultural transactions and short-term paper secured by obligations of the United States Upon the security of paper eligible for discount or purchase the reserve banks may make advances to their members upon promissory notes for periods not over 90 days, upon the security of obligations of the United States or certain other securities, for periods not over 15 days They may lend to members, upon satisfactory security, at a rate ½ of 1% higher than that applicable to discounts and advances of the kinds mentioned above for periods not over 4 months. Under certain conditions advances may be granted to groups of member banks

An amendment to the Federal Reserve Act on June 19, 1934, provides that the Federal Reserve banks may extend credit to furnish working capital to established industrial or commercial businesses for periods not over 5 years, either through financing institutions or directly, and may make commitments for this purpose When five members of the Board of Governors grant authority, the Federal Reserve banks, in exceptional circumstances and under certain conditions, may discount for individuals, partnerships, or corporations notes, drafts, and bills of exchange eligible for discount by member banks and, subject to Federal Reserve Board regulations of the Board of Governors, may make advances to them for periods not over 90 days upon their promissory notes secured by United States obligations.

The Federal Reserve banks may purchase and sell on the open market bankers' acceptances and bills of exchange eligible for discount, United States obligations, and certain other securities, may issue Federal Reserve notes and Federal Reserve banknotes, receive and hold for deposit reserve balances of member banks, act as clearing houses and as collecting agents for the member banks, and sometimes for nonmembers, in the collection of checks and other instruments, act as depositories and fiscal agents of the United States, and exercise other banking functions specified under the Federal Reserve Act

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